Municipal Fiscal Reform in Ontario: Property Taxes and Provincial Grants

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John Bossons,
Michael Denny, and Enid Slack

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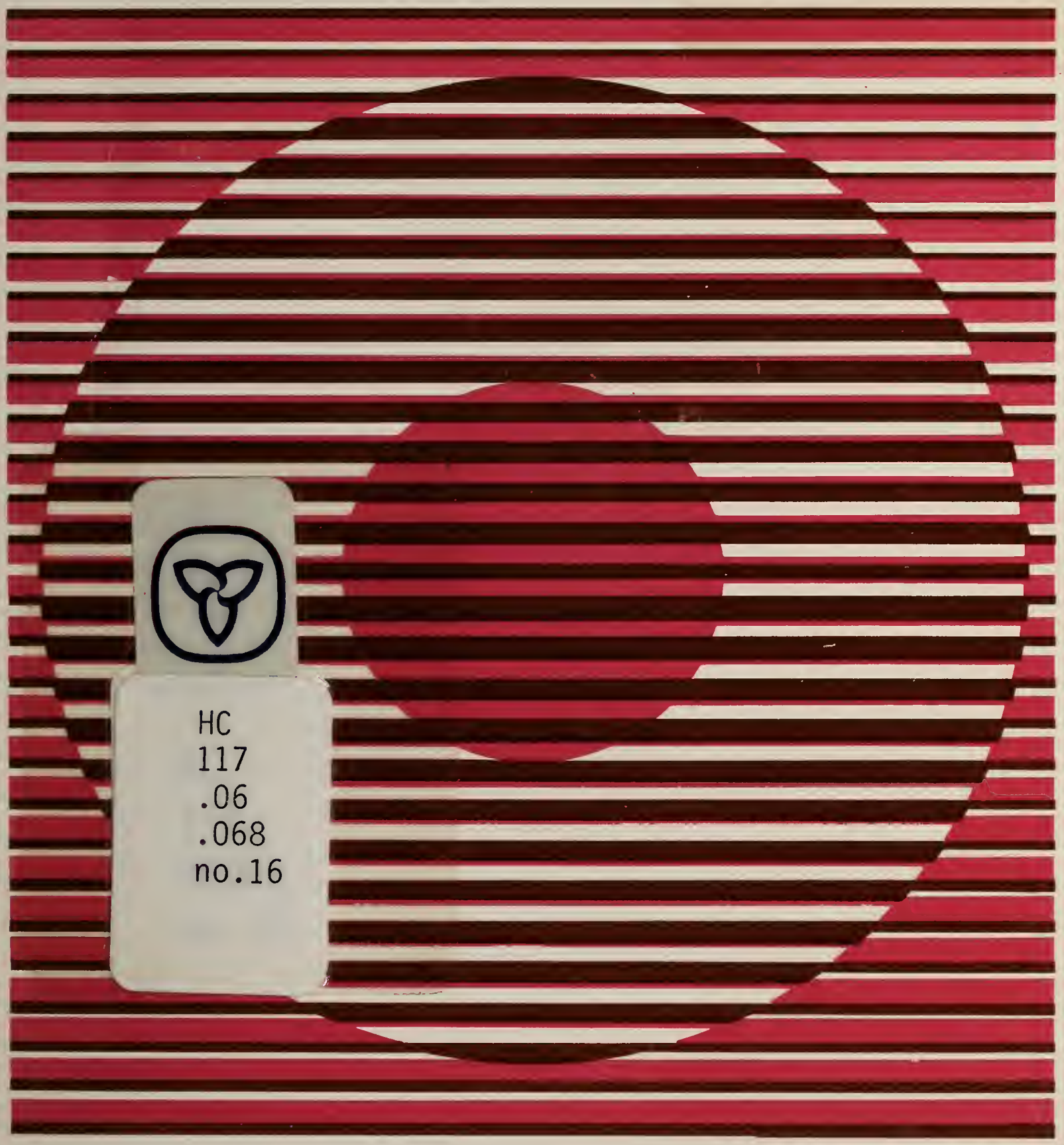

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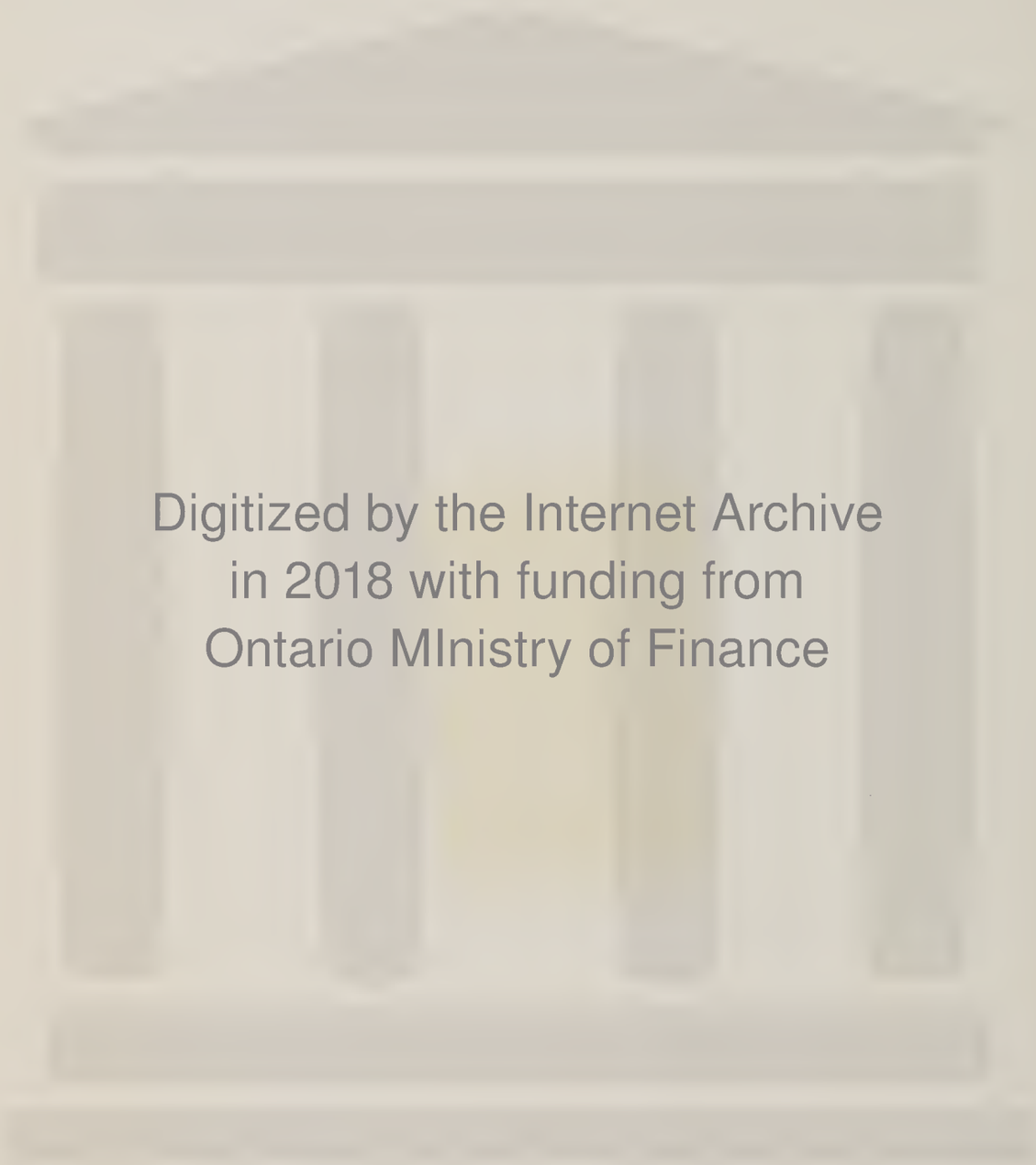

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by John Bossons, Michael Denny, and Enid Slack

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John Bossons and Michael Denny are members of the Department of Political Economy at the University of Toronto. Enid Slack is a research officer with the Ontario Economic Council.

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Introduction

HISTORY OF PROPERTY TAX REFORM: THE RETREAT FROM UNIFORMITY

The modern history of property tax reform in Ontario began with the report of the Ontario Committee on Taxation (Smith Committee) in 1967. Although it recognized the value of the property tax as an important source of local revenue to be used for local purposes, it criticized the tax for being regressive and inequitably administered.

This conclusion was based in part on a study of the relation between assessed values and market values undertaken by the Committee using data for twenty-two Ontario municipalities in 1961-3.[1] This study found that the ratio of assessment to market value was lower for single-family homes than for apartments. In other words, apartments were assessed relatively higher in relation to their market value than single-family homes in the same municipality. The study also found that the tax structure discriminated in favour of land without buildings. Inequities were found to exist between municipalities as well as within them.

The Smith Committee recommended that real property be assessed at 'actual' value and that the Province take an increasing role in the assessment process. In response to the Smith Committee report, the Province took over the assessment function entirely from municipalities in 1970, a step that went beyond even the Committee's recommendations. In addition, the government made a commitment to adopt full market value assessment throughout the province.

The first attempt to implement market value assessment was in the Town of Mississauga in 1970. There resulted a number of tax shifts, notably from commercial and industrial properties to residential properties. It was also found that within the residential class taxes were shifted from newer single-family residences to older single-family residences.[2]

The Mississauga experience and others showed how the current pro-

1 Report of the Ontario Committee on Taxation (Toronto: Queen's Printer, 1967), II, Appendix to Chap. 13

2 Market Value Reassessment (Toronto: Bureau of Municipal Research, 1970). This study, discussed more fully in Michael Denny's paper, shows the impact of a move to market value assessment.

perty tax differs from a tax proportional to market values. Effective tax rates on market value are lower for residential property than for commercial and industrial property, higher for apartment buildings than for single-family homes, higher for newer buildings than for older ones, and probably higher for low-valued rented residence units than for high-valued units.[3] Land values are usually underassessed.

The move to adopt market value assessment across the province has therefore become highly controversial. Consequently the provincial government has several times postponed its introduction. The current debate began with a series of reforms proposed in the 1976 Ontario budget.[4] Among the proposals were ways of avoiding some of the major tax shifts or at least lessening their impact.

The most important recommendation was that residences be taxed on 100 per cent of market value.[5] The tax on farm property was to be borne by the Province; the business tax was to be a uniform additional 50 per cent of the normal property tax on market value; exemptions were to be reduced; assessment on provincial government property would be pooled and assigned between public and separate elementary schools in the same proportion as residential assessment; and property taxes paid by school boards would be treated as allowable expenses for grant purposes. It was proposed that 1975 market values be applied for 1978 tax changes.

The government appointed a commission (chaired by W.L. Blair) to consider these recommendations. After several hearings and many hundreds of briefs, the Blair Commission reported its findings in March 1977. It supported the main thrust of the 1976 proposals but extended and altered a few of the ideas. For example, it proposed that farmers pay 10 per cent of the assessed taxes with the Province paying the remainder, that exemptions be extended slightly, and so on.

In January 1978 the government issued another plan for property tax reform, entitled the 'Alternative System,' and announced the creation of a joint provincial-municipal committee to study it.[6] The new scheme generally

3 Cf. also Bird and Slack, Residential Property Tax Relief in Ontario (Toronto: University of Toronto Press for the Ontario Economic Council, 1978), Chap. 1.

4 Ontario Budget 1976 (April 1976), Budget Paper E

5 In all of these proposals property values are assumed to be assessed at market values. Taxable assessment is then defined as a varying proportion of assessed value.

6 Remarks by the Hon. Darcy McKeough, Treasurer of Ontario, on property tax reform, 4 January 1978

included the earlier reform proposals but moved further towards a classified assessment system with different proportions of assessment being taxable on different classes of property. The existing differentials for business properties would be altered only slightly. Instead of the 1976 proposal to have a uniform business assessment at 150 per cent of market value, the Alternative System would have business assessments ranging from 130 per cent to 240 per cent of market value. All farm taxes would be paid by the Province, with no recovery provision. Most current exemptions would also be continued. The 1975 market values would be introduced in 1978 for application to property taxes in 1979, and there would be a five-year discretionary phase-in period.

The provincial-municipal committee studying the plan reported in April 1978.[7] It recommended two major changes: that taxable assessments for multiple residences (more than five units) be 75 per cent of market value and that Metro Toronto be allowed, for up to three years, to set taxable assessments for single and multiple residences at 45 and 80 per cent of market value rather than the 50 and 75 per cent recommended for other municipalities. Once again an attempt was being made to move away from rigorous market value assessment in order to minimize tax shifts.

One perhaps unexpected result of the work done by the provincial-municipal committee was the publication of fairly extensive data on the tax shifts that would result from the various reform proposals. Following public reaction to this information, the government decided not to proceed further with overall reform. In June 1978 the then Treasurer of Ontario, Darcy McKeough, announced that property tax reform would not be implemented in the near future.

THE CURRENT SITUATION: REFORM THROUGH ADMINISTRATIVE ACTION

Events since Mr McKeough's announcement have made it clear that the retreat from overall reform does not imply that the property tax will remain unchanged. Indeed, the data whose publication led to the rejection of the reform proposed by the government emphasized the wide discrepancies in assessment for comparable properties. Many property owners appealed their assessments. Moreover, the retreat from property tax reform left untouched

7 Report of the Provincial-Local Government Committee on Property Tax Reform, April 1978

what were widely perceived as inequities in the provincial grants given to municipalities.

In response to these two problems, the Minister of Revenue announced two new reforms in November 1978. The first was that municipalities could, if they wished, apply to the Province under Section 86 of the existing Assessment Act to reassess classes of property such as residential, commercial, and industrial.[8] Variations in ratios of assessment to estimated market value would be removed within classes of property, but there would be no change in total assessment for each class. This use of Section 86 was deliberately designed to reduce the number of appeals resulting from claims by property owners that their property was overassessed compared to neighbouring properties.

The Minister of Revenue also announced that the freeze in effect since 1970 on equalization factors for provincial-municipal grants and cost apportionment would be removed.[9] New equalization factors reflecting 1978 market values would be produced in 1979 for the purpose of education grants and resource equalization grants, but he promised that no municipality would receive a smaller grant in 1980 because of the introduction of these new factors.[10] Also, special one-time payments were made in 1979 to the forty-nine Ontario municipalities most adversely affected by frozen

8 For a discussion of the use of Section 86, see Bossons below.

9 Equalization factors are applied to the taxable assessment base of a municipality to arrive at a figure for equalized assessment which is used largely as a basis for apportioning costs and grants (specifically, the education grant and the resource equalization grant). Although equalized assessments are somewhat closer to market value than are taxable assessments, the equalized values still understate market values, in part because the equalization factors have been frozen since 1970 because of the discussions on assessment and property tax reform. Equalization factors are different for school purposes and general municipal purposes. Prior to the reorganization of school boards in 1969, these factors were the same, but because the reorganization would have resulted in significant tax shifts, education equalization factors began to be calculated on the basis of an average of earlier years. This means that equalized assessment used for school cost apportionment and education grants are even further removed from market value assessment than is the equalized assessment used for municipal purposes.

10 It is not clear what this statement by the minister really means. It could mean, for example, that the grant in 1980 will not be smaller than it would have been with no change in equalization factors. Alternatively, it could mean that the grant will not be less than the previous year, implying no growth in the nominal grant amount but a decline in real terms. In any case, the statement provides only a temporary and transitional benefit for the affected municipalities.

equalization factors.[11]

Reassessment under Section 86 was done by thirteen Ontario municipalities effective in 1979. More than fifty other municipalities intend to do so in the 1980 tax year.[12] In short, some tax reform (at least within classes of properties) is in fact occurring. Moreover, the proposed changes in provincial-municipal grants would shift some of them among municipalities and force local taxes to become more closely related to market values across the province. These important changes are occurring in the absence of legislation.

ISSUES

In the numerous discussions of property tax reform in Ontario, very little has been said about objectives. The primary goal of reform has been stated as making the tax system 'equitable,' where equitable has been assumed to mean that property taxes are everywhere the same proportion of market value. The obstacles that have postponed property tax reform on several occasions are widely seen as political. They have certainly been very difficult to overcome.

In fact, the issues involved are much more complex than the debate has acknowledged. Even the definition of equity is complicated. And as in any tax reform issue, there are tradeoffs between the achievement of equity and other economic and social goals. Other matters which must be considered include effects on neighbourhoods, on investment, on local autonomy, on provincial-municipal transfers, and on the municipal fiscal system in general. These and other issues are addressed in the three papers in this volume.

The papers have been commissioned by the Council to analyse various aspects of municipal finance in Ontario. The first paper, by Michael Denny, was originally commissioned as a review of the 1978 government proposals for property tax reform. Partly as a response to some of the issues raised in Denny's paper, the Council commissioned a second paper,

11 It is estimated that these grants will total $6.6 million; approximately two-thirds of that amount is awarded to Windsor and Sudbury. Statement by the Hon. Thomas Wells, Minister of Intergovernmental Affairs, 19 March 1978

12 Statement by the Hon. Lorne Maeck, Minister of Revenue, 21 November 1978

by John Bossons, to analyse the problems underlying property tax reform in more detail. The related problem of reforming provincial-municipal grants is dealt with in the third paper, by Enid Slack.

Michael Denny reviews the notion of equity and what it means in the context of property tax reform. He analyses the long-run consequences of tax reform on the viability of older downtown shopping areas, on single-family homes, and on the construction and pricing of new residences. He investigates the impact of market value assessment in the Region of Peel in 1970 and the expected impact of the 'Alternative System' proposed by Darcy McKeough. Although market value assessment is based only on an estimate, it is not easy to measure and may not provide a truly good indication of equity, Denny concludes that it is still practical, visible, and fairly easy for taxpayers to comprehend. He proposes that Ontario move to market value assessment as the base for the property tax. He points out that market value assessment does not mean that property taxes have to be the same proportion of market value for all properties. He recommends that local governments be allowed to set effective tax rates for single-family dwellings, apartments, and all other property.

John Bossons questions the provincial government's assumption that property taxes ought to conform to market value assessment. He discusses the problems associated with determining equity and argues that it is easier to define equity <u>within</u> classes of property than across them. He contends, therefore, that property tax reform should concentrate on increasing within-class equity. Many of the existing variations in ratios of assessment to market value might well be maintained, he suggests. Reasons for maintaining these differentials include differences in relationships between the market value and the taxpayer's ability to pay, user charges reflected in existing deviations of assessments from market values, and economic problems (such as effects on investment) that might be caused by tax changes. More attention, be believes, should be given to incorporating user charges into the municipal tax structure. This could be done either by making assessment depend in part on service benefits or social costs or by levying additional taxes such as on municipal services and gasoline.

Bossons' paper proposes comprehensive reform based on a classified assessment scheme but differing from the current use of Section 86 in recommending a finer classification. In particular, he recommends that residential properties be differentiated by type to reflect the differences in

costs of servicing and in the ratios of market value to actual or imputed rent. He also recommends differentiating small retail stores from other commercial property, and commercial property in the central business districts of large cities from properties in other locations. To reduce unwanted redistributive and economic side effects of adopting a classified market value assessment scheme, he proposes phase-in mechanisms and investment incentives as an essential part of the reform.

The primary objective of the reforms proposed by Bossons is the rationalization of the current property tax to eliminate the most obvious inequities within classes. Such a rationalization should, he suggests, be regarded as no more than a first step. To go beyond this, he proposes that municipalities be empowered to change the ratios of assessed value to market value for particular classes of property, subject to the procedural safeguards (including review by the Ontario Municipal Board) that now apply to zoning changes.

In reviewing the equity arguments for differential taxation of different classes of property, Bossons concludes that the only classes that are clearly being taxed excessively in relation to other classes are industrial property and local retail property. He proposes that such property should be exempt from education taxes and that the resultant loss in municipal revenue be offset by increases in provincial grants.

Another issue is the relationship between property taxes and provincial-municipal grants. Grants and property taxes are obviously closely related, because the less a municipality receives in grants, the more it is going to have to raise in property taxes. And certain grants, specifically those for education and resource equalization, depend in part on the property assessment of the municipality. Simplifying greatly, we can say there is an inverse relationship between assessment and the amount of the grant - as the property assessment of the municipality rises, the amount of its grant falls.

All three authors recognize the interdependence of grants and property taxes and strongly recommend that they be reformed at the same time. A proposal for a new approach to equalization is made in Bossons' paper.

The question of property tax reform leads to a consideration of the whole municipal finance system. That is the subject addressed by Enid Slack, who evaluates the current grant structure in Ontario and analyses

recommendations put forward by the Provincial-Municipal Grants Reform Committee.[13]

The objectives of grants are considered - economic, political, and institutional. The various grant programs are then evaluated against these goals. Also reviewed is the budgetary response of local governments to grants.

Slack concludes that conditional grants in Ontario (grants designed for specific purposes) probably do not improve efficiency and that unconditional grants (grants which can be spent on any function) do not achieve equity. Little has been done in the last decade to reform the grant structure, and some recommendations are made for simplifying grants generally and for improving unconditional grants. Clearly, as stated earlier, property taxes and provincial grants are both in need of reform.

As noted earlier, although formal property tax reform appears to have been halted in Ontario, it is taking place in practice through administrative action. It is hoped that these papers will highlight the consequences of the current changes and encourage discussion of the types of reforms that are desirable.

13 Report of the Provincial-Municipal Grants Reform Committee (Toronto, 1977)

Property Tax Reform: What is Desirable?

John Bossons

The discussion of property tax reform in Ontario, though widespread, has concentrated on matters of detail rather than on issues of principle. That may seem curious, but it is probably the result of a nearly universal assumption by economists, civil servants, journalists, and politicians that the 'ideal' property tax is one in which taxes are proportional to the current market value of property. Given this assumption, the only 'problems' to be dealt with in analysing property tax reform were the resolution of technical difficulties and the working out of politically feasible compromises with objectors.

If this nearly universal assumption were true, then what has happened in Ontario to property tax reform would have to be regarded as an unmitigated disaster - an illustration of the ability of affected interest groups to block important, socially desirable change. The progressive dilution and subsequent abandonment of government proposals for the introduction of substantive market value assessment have been described in the first paper in this volume.

The purpose of this paper is to demonstrate that analysts have made an important error in assuming that taxation in proportion to market value represents the desired ideal. One reason for this error is that making property taxes uniformly proportional to market value would have unfavourable side effects even if such a tax system were clearly equitable. A more devastating reason is that it is not even true that taxation in proportion to market value results in an equitable property tax.

Because of the importance of the equity argument in the case usually made for introducing market value assessment, that argument is considered

The author is greatly indebted to Richard Bird and John Tylee for their extensive comments on an earlier draft. The paper has also benefited from comments by Richard Arnott, John Due, Ann Golden, Angus MacKay, Stan Makuch, Oliver Oldman, and Peter Tomlinson. An earlier version was presented to an OEC seminar in Kitchener in November 1978. I am grateful to the participants in that seminar and in particular to Jane Bigelow, Jack Young, and David Winch for their comments. The proposals for grant reform were discussed at a conference on property tax reform issues sponsored by the University of Toronto Centre for Urban and Community Studies in March 1979; comments by Hugh MacKenzie and other participants were helpful.

at some length in this paper. A tax must be reasonably equitable to be accepted by taxpayers, and it is important to define what 'equity' means and whether it can be achieved. This is done in the first four sections of this paper.

The discussion of equity and of market value assessment is complicated by the fact that these words are frequently used to mean different things. To clarify subsequent discussion, sources of confusion are described in Section 1 and some important terms defined. The second section deals with the central question of the paper: namely, what is the relationship between property market value and the taxes that should be paid under an equitable property tax? This question is analysed both in general terms and in the specific context of taxes on residential property. The additional problems of analysing property taxes on non-residential property are described in Section 3.

One of the conclusions reached in the first three sections is that market value is a particularly imperfect basis for allocating property taxes across different types of property. However, this leaves open the question whether it may be an equitable basis for allocating taxes among similar properties. Could an equitable tax system be achieved by use of a classified assessment scheme, in which taxes are made proportional to market value within classes but with varying effective tax rates on market value for different classes? This question is discussed in Section 4.

The long-term equity of a tax system or its alternatives is only one of a number of considerations in evaluating proposals for change. For one thing, a particular tax system may be equitable but still not desirable because of its economic or social consequences. For another, even with a better alternative the transitional costs resulting from a change in the property tax may more than offset the present value of the long-term gains that would be achieved by the change. These questions are considered in Sections 5 and 6.

The current property tax in Ontario has many problems. To deal with some of them, the provincial government has allowed municipalities to initiate a limited reassessment of properties that yields a form of classified assessment. The current problems and the government response are evaluated in Section 7.

The conclusion of this paper is that a classified assessment scheme provides a structure within which the equity of the property tax may be

improved, and that the resulting tax system would be more equitable than a system in which property taxes are uniformly proportional to market value. This conclusion, dramatically opposed to the nearly universal presumption of most analysts, provides the basis for specific proposals for property tax reform in Section 8. These proposals reflect both the equity arguments of the first four sections of the paper and the other considerations introduced in subsequent sections.

This paper is primarily concerned with the structure of the municipal property tax. A separate but closely related issue is the structure of equalization grants from the provincial government to municipalities. The considerations of equity that are important in allocating property taxes among individuals are also relevant to the allocation of provincial grants that reduce property taxes for municipal aggregates of individuals. The implications of these equity considerations for the structure of provincial grants to municipalities are discussed in Section 9.

1 SOME COMMON SOURCES OF CONFUSION

One of the problems in discussing property tax reform is that some terms mean different things to different people. Consequently it is important at the outset to define terms.

Two concepts are particularly frequent sources of confusion because they may legitimately be used to mean different things. The multiple meanings of market value assessment and of equity are defined below.

Before turning to these it is useful to define how 'tax reform' itself will be interpreted. One problem in discussing property tax reform is that to many citizens 'reform' has become a codeword for tax increases. This widespread fear that a change in the structure of property taxes or provincial grants to municipalities will be used by governments as a means of introducing a disguised tax increase makes the political implementation of reform more difficult. In this paper it will be assumed that 'reform' means a change in the structure of property taxes and provincial grants to municipalities without any change in municipal expenditures or in total taxes.

The multiple meanings of 'market value' assessment

In effect, there are three distinct links between property values and pro-

perty taxes. These links are important to distinguish from one another, even though they are often collapsed into one in popular discussion. They consist of three relationships: (1) the relationship between property tax and taxable assessment, (2) the relationship between taxable assessment and appraised value, and (3) the relationship between appraised value and market value. For any particular property, these relationships may be summarized by three ratios, which when multiplied together define an 'effective tax rate' on market value. Algebraically, this statement may be expressed by the equation

$$ETR = \frac{T}{TA} \frac{TA}{AV} \frac{AV}{MV},$$

where ETR is the effective tax rate on market value (i.e. the ratio of property tax to market value), T is the property tax accrued, TA is the taxable assessment, AV is the appraised value, and MV is the market value. The first of these three ratios (T/TA) is simply the municipal mill rate. The second (TA/AV) is the ratio of taxable assessment to assessed market value; it allows for legislatively defined differences between taxable assessment and appraised value. The third ratio (AV/MV) measures the accuracy with which appraised value reflects the current market value of the property.

To understand the debate over property tax reform it is necessary to realize that different individuals writing or speaking on the subject have interpreted 'market value assessment' in varying ways. Some have assumed simply that the third ratio in the above formula would be made equal to unity, so that 'appraised values' should (at least in principle) everywhere be equal to actual market value as of some recent benchmark date. (Appraised values now differ substantially from actual market values, partly as a result of not having been consistently updated.) In this interpretation, each of the other two ratios might vary across different properties both within and among municipalities. At the other extreme, others have assumed that 'market value assessment' would mean that both the second and third ratios would everywhere be equal to unity, and that there would in addition be only one mill rate in each municipality. Under this second interpretation, there would be a single value of ETR for all properties within a municipality, though effective tax rates would vary among municipalities because of differences in mill rates. Other interpre-

tations lie between these two extremes.

Needless to say, this range of interpretations is substantial. It is consequently no surprise to find not only that individuals have meant different things when they propose market value assessment but also that other individuals have interpreted such proposals in varying ways. It will consequently be useful to define some terms in an attempt to avoid confusion. The first interpretation of market value assessment (as concerned only with AV = MV) will be called 'administrative market value assessment.' The term 'administrative' is used to emphasize the fact that a move to market value assessment is in this interpretation primarily concerned with eliminating the administrative problems, taxpayer confusion, and assessment appeals caused by the effective absence of a clear definition of the basis for assessment. By permitting variations in mill rates and/or ratios of taxable assessment to appraised value within a municipality, this approach does not in itself require any redistribution of property taxes among types of property. The second interpretation will be called 'substantive market value assessment.' The term 'substantive' is used to emphasize that what is desired in this case is a uniformity of effective tax rates on market values within a municipality.

The multiple meanings of equity

'Equity' has more than one dimension. It may mean uniform treatment of taxpayers who happen to be in identical circumstances. ('Horizontal equity' or 'fairness' are synonyms for this aspect of equity.) It may imply more generally that taxes are imposed on taxpayers in different circumstances in a way that reflects their different abilities to pay. (This dimension is often called 'vertical equity'.) Finally, it may imply that differences in taxes reflect differences in the benefits received by taxpayers from the services paid for by such taxes. (The latter dimension reflects the possibility that some taxes may be justified as a form of user charge.)

The distinction between 'horizontal equity' and the two possible dimensions of vertical equity is an important one. Vertical equity is concerned with how dissimilar taxpayers should be taxed. There is generally less agreement on how ability to pay or benefits from services should be defined and weighted to tax dissimilar individuals equitably than on the notion of horizontal equity. Regardless of how these other dimensions of

equity are weighted, taxpayers in identical circumstances (with equal ability to pay and receiving equivalent municipal services) should in equity pay the same tax. This principle is generally recognized as valid by taxpayers. Indeed, it is precisely departures from horizontal equity that are most frequently cited as demonstrating the need for property tax reform; 'fairness' in the sense of the occurrence of reasonably few perceived deviations from horizontal equity is a minimum requirement for taxpayer acceptance.

The distinction between equity in the sense of reflecting ability to pay and equity in the sense of reflecting the different benefits received by taxpayers from municipal expenditures is an important one. Not all municipal expenditures generate benefits that can be allocated to individual properties or classes of property. Nevertheless, an important component of municipal expenditures either provides allocable benefits or is provided at costs which vary with location or type of property. Such items include property-specific and locality-specific services as well as municipal public goods (such as highways and public transit) for which aggregate demand and supply costs differ by type and location of land uses; they will be identified below as 'property-related services.' They make up most of 'local' municipal expenditures apart from expenditures on education and social services.

Expenditures on property-related services give rise to costs and benefits which are allocable to individual consumers who either receive identifiable benefits or are the cause of differential costs. For this component of municipal expenditures, the 'user cost' dimension of equity provides the appropriate guide to both horizontal and vertical equity.

Other municipal expenditures provide services that are of more general social benefit or are necessarily redistributive in nature. Expenditures on social services and education may yield benefits to recipient individuals but cannot be financed by user charges. Here they will be termed 'general expenditures' to distinguish them from property-specific expenditures. They should be financed by 'general taxes,' for which the definition of equity is based on the ability to pay.

Because of the importance of equity in the recent Ontario discussion of property tax reform, this question will be examined at some length. Two general aspects of it will be discussed: (1) the extent to which the property tax is equitable as a means of paying for property-specific services

and (2) the extent to which a local property tax may be equitable from the standpoint of ability to pay as a means of financing general expenditures. In Section 2 these questions will be discussed primarily as they apply to residential property. The equity of the property tax on non-residential property will be discussed in Section 3.

2 HOW EQUITABLE IS A PROPERTY TAX THAT IS PROPORTIONAL TO MARKET VALUE?

In evaluating any proposed tax reform, it is necessary to consider a number of dimensions along which the proposed tax change can be measured. These include different aspects of tax equity, the extent and incidence of redistributive wealth transfers that would be caused by implementing the proposed reform, and the effects of any changes in decision-making behaviour that the tax changes might cause.

Though the consequences of making effective property tax rates on market value more uniform must be considered in terms of all these different dimensions, the equity dimension has been central in public discussion. Equity considerations have frequently been implicitly assumed to 'require' the implementation of substantive market value assessment in which ratios of property taxes to market values are made uniform. The validity of this assumption is thus crucial.

An improvement in the equity of property taxation has been a principal objective underlying proposals for market-value assessment. As the Blair Commission stated,[1]

> We concur ... with the government's position that market value is the only basis upon which a property tax system with acceptable criteria of fairness and equity may be built and may last ... Accordingly, the commission determined its (first) principle to be that all real property be assessed at market value.

Though often adopted only implicitly, the assumption that market value is 'the only basis' for defining an equitable property tax is of key signfi-

1 Report on the Commission on the Reform of Property Taxation in Ontario (Toronto: Queen's Printer, 1977), 9. The Commission's 'first principle' has been normally interpreted as meaning substantive market value assessment, even though qualified by departures from this principle in politically sensitive areas.

cance. Much of the pressure for changing the property tax system has been motivated by a belief that making all property taxes more uniformly proportional to market values would increase equity and therefore be desirable.

How or why this notion has arisen in not clear.[2] A tax proportional to real estate property values is not necessarily equitable. A property tax has a number of useful attributes. However, what makes the property tax useful (chiefly its feasibility and identifiability as a local tax) does not necessarily make it promote equity. Rather, the property tax is useful as a local tax in spite of the fact that it is inherently not ideal from an equity viewpoint.[3]

This section considers how a municipal property tax should ideally be implemented when applied to residential property. The allocative and redistributive effects of such a tax will be discussed at this point only insofar as they affect its equity. My object is to clarify what is desirable from the viewpoints of tax equity and tax neutrality. The actual incidence of the tax and of reform-induced tax changes will be discussed later, together with its allocative effects.

The tax as a substitute for user charges

A user charge embedded in the tax system is a quasi-price, imposed on consumers of services that are not exchanged in private markets. As such, it is a substitute for the market price that would arise if the service were traded in a private market. It may be viewed either as a way of reflecting differential demand for a public service (i.e. the allocation of benefits) or as a proxy for differences in the incremental costs of supplying public services to different individuals, land uses, and localities. Each potential justification for user charges will be discussed in turn.

The property tax has often been regarded as at least in part justifi-

2 This notion may be a carryover from an earlier time in which most wealth took the form of real property, mortgages were rare, and most income differentials were the result of income from wealth.

3 The property tax (meaning a tax assessed on the basis of the value of real estate owned by a taxpayer) is a large component of local tax revenues only in Canada, the United States, certain other former British colonies, and the Netherlands. For example, in Germany and Sweden (where local governments are strong) the property tax is relatively unimportant; local revenues are derived primarily from taxes on business or from local income taxes.

able on the basis that variations in the tax (at least across different municipalities) reflect differences in local expenditures whose benefits accrue to local property owners.[4] If tax differentials within a municipality can be made to reflect differences in services provided to owners of property, the property tax may be regarded as a crude way of pricing such services. (Presumably the property tax, from this viewpoint, would be used as an indirect means of imposing user charges to avoid the higher administrative costs of implementing direct user charges or because of the non-exclusivity of benefits provided by the services of local governments.)

Needless to say, the extent to which the property tax may be regarded as a crude user charge for benefits allocable to properties depends on the extent to which its incidence within a local municipality coincides with the distribution of benefits provided by municipal services. Two factors are relevant: the fraction of municipal expenditures financed by the property tax which can be regarded as generating benefits specific to different localities within a municipality or to different classes of property, and the extent to which locality-specific or property-specific benefits vary in proportion to assessed property values in each locality and/or property type. Empirical analysis of these factors is difficult because of the lack of disaggregated 'social indicator' data, though casual observation suggests that there is significant variation in the provision of public goods to different localities and property types.[5]

The nature of local public services is such that the market value of property is not a very good proxy for either the marginal cost of providing services to the property or the marginal benefit received from such

4 For example, cf. Spengler, 'The property tax as a benefit tax,' in Property Taxes (Tax Policy League, 1940). An extension of this argument is provided by the Tiebout model, in which intermunicipal variations in locally financed public expenditures provide (through locational choice by households) the basis for a socially optimal allocation of public services; cf. Tiebout, 'A pure theory of local public expenditure,' Journal of Political Economy, October 1956; Wooders, 'The Tiebout Hypothesis: near optimality in local public good economies,' Econometrica, forthcoming. Taxes are assumed to be lump-sum in this model; these taxes turn out to be approximately equal to the Lindahl prices in the Lindahl-Musgrave voluntary-exchange model; cf. Musgrave, The Theory of Public Finance (McGraw Hill, 1959), 74-7.

5 See for example the discussion in Shoup, Public Finance (Aldine, 1969), 111-27. A tendency to coincidence in the distribution of local services and local taxes may also be predicted using political coalition-formation models.

services to the owner or user of the property. Indeed, no single variable is likely to be a very satisfactory basis for the allocation of the benefits of local tax-financed public goods, since different municipal services convey benefits which are differently distributed. Were such benefits to be financed by separately administered user charges, it would be necessary to have a family of user charges clearly linked to the benefits provided by different municipal services.[6]

Vickrey has suggested a number of benefit taxes, each related to specific local municipal services.[7] Interestingly, the basis for each of these service-specific user charges is a variable which is a component of traditional assessment practice. For example, front footage is specified as the appropriate variable by which to allocate the costs of a number of 'hard services,' including water and sewage connections as well as local roads. For individual houses, lot area is suggested as the basis for allocating the costs of fire protection services, reflecting the effect of the density of development on the cost of providing protection services of a given quality. To the extent that variables such as front footage or lot area are in fact correlated with property tax rates (expressed as fractions of market values) in the current tax system, such variations in tax rates may appropriately reflect differences in the costs of providing benefits.

Some evidence that such differentials are reflected in the current property tax is provided in a study by Denny and Grainger.[8] This study indicates that, for residential properties, the ratios of property taxes to the market value of each property are increased by such factors as lot size and zoning for single families (R1 or R1F zoning), which may serve as

6 Such an approach has recently been proposed by the U.S. Advisory Commission on Intergovernmental Relations. Cf. Advisory Commission on Intergovernmental Relations, Local Revenue Diversification (Washington DC, 1974). The Commission recommended that state governments adopt affirmative policies regarding local user charges, including provision for their indexation to general price inflation and technical assistance to municipalities in developing user charges.

7 Vickrey, 'General and specific financing of urban service,' in Schaffer, ed., Public Expenditure Decisions in the Urban Community (Resources for the Future, 1963), 64-86

8 Denny and Grainger, 'An imputed property tax decision rule,' Working Paper 7409 (University of Toronto, Institute for Policy Analysis, 1974), especially Table IV. This table provides the coefficients of a regression of property tax/market value ratios on property characteristics for a sample of 680 properties in the City of Toronto.

proxies for front footage and density.[9] The effect of front footage is also reflected in the negative effects on tax/value ratios of dummy variables for properties in which the houses are semi-detached or row houses. While not all deviations from a fixed tax/value ratio are proxies for potential 'user charges,' this source of deviation is a statistically significant component of the total variation of tax/value ratios in the Denny-Grainger sample,[10] a fact that should be kept in mind when evaluating the overall equity of the current municipal property tax in Ontario.

There are of course two ways in which implications may be drawn from the present situation. One is that, with an insufficient reliance on user charges by municipalities, it could be desirable to keep those current variations in the ratios of taxable assessment to market values which reflect cost-related factors such as front footage and density. The other (equally correct) approach is to implement a wider municipal reliance on user charges for the financing of municipal services and, having done so, to reduce the extent to which user charges are indirectly implemented by being built into the property tax. From the viewpoints of taxpayer comprehension and the encouragement of efficient resource allocation, the second would be preferable.[11] The first approach is a 'second best' policy that examines the property tax in a context where the use of municipal user charges is not expanded or is determined to be too expensive to administer separately.

The tax as a means of allocating social costs

The previous discussion has focused on user charges for municipal services

9 They may serve as proxies also for perceived income. There is some evidence (see preliminary report of the City of Toronto Task Force on Property Tax Reform) that local assessors implicitly tended to assess properties of lower-income households at a below-average fraction of market value.

10 The reader should be cautioned not to assume that these results imply that assessors meant to incorporate such 'user charges' into the property tax base. Rather, what is implied is that (whether by accident or design) the current property tax in Toronto contains features which are consistent with a benefit-based definition of equitable assessment.

11 For a comprehensive discussion of additional user charges at the municipal level, see Bird, Charging for Public Services: A New Look at an Old Idea (Toronto: Canadian Tax Foundation, 1976), chaps. 6-7 and 10-13.

whose benefits can be identifiably allocated to specific individuals. In such cases, user charges may be thought of as a way in which the allocative benefits of market pricing may be introduced into the provision of services that (for reasons of technical efficiency) are provided by a municipal government.

It is not necessary to be able to allocate specific benefits to individual properties for user charges to be appropriate. Part of the rationale for user charges is that, even if there is no differential incidence of the benefits of local public services, the costs of providing local services are likely to vary in different parts of a municipality as a result of differences in the density of development. Reflecting the effects of such differences in the property tax system is one way in which some of the social costs associated with different development patterns may be allocated to properties. Since the resultant tax differentials will be taken into account when property owners and developers make land use decisions, incorporating user charges in the property tax may lead to a socially more efficient allocation of resources and be more satisfactory on one dimension of equity.

The inclusion in the property tax of tax differentials to reflect the social costs associated with different development patterns goes beyond the normal concept of user charges for municipal services. For example, a user charge to recover the costs of highway construction and maintenance would normally be presumed to be some form of levy on the driver of automobiles or on the owner of motor transport.[12] This presumption reflects the belief that the most important allocative role of user charges is its effect on marginal use decisions and that the ability to reflect varying marginal use costs is of particular importance. Although such allocative effects are obviously not unimportant, the underlying land use decisions that affect the costs of providing highways or transit services have a greater impact on municipal finance. Those decisions can be influenced as effectively by an annual tax differential that reflects the average annual incremental social cost associated with particular development patterns as by a more sophisticated set of highway and transit user charges that varies with the time and place of use.

The potential role of the property tax as a means of more equitably reflecting general social costs is of particular importance in larger urban

12 Cf. the alternative highway user charge proposals by Haritos, Walters, and others summarized in Bird, Charging for Public Services, 59-60.

areas. There the marginal social costs associated with particular land uses reflect not only the costs of providing municipal services but also the social costs of global externalities associated with such land uses. A 'global externality' is an effect on other consumers or producers that narrows the range of choices available to them but which occurs as a result of changes in the aggregate amount of particular types of land uses rather than from individual uses.[13] One of the more important effects of postwar private and public decisions on residential development patterns has been the widespread growth of suburban low-density residential developments oriented away from arterial roads. Because such developments are hard to service effectively by public transit, their growth has led to higher average costs per rider of providing transit services, along with more automobile congestion (particularly on transportation routes oriented to the inner cores of metropolitan areas). Both results imply social costs, whether through their direct effect in restricting other individuals' feasible sets of consumption alternatives (congestion externalities) or by causing increased taxes to pay for additional transportation investments and transit deficits. Because these costs are directly associated with density of development, it would be appropriate on equity grounds to reflect them in a 'density tax' that was inversely proportional to density.[14]

In addition to reflecting the social costs associated with the negative global externalities associated with low-density development, a density tax could also be used as a rough proxy for the user charges for municipal services described in the preceding subsection. What empirical evidence is available largely supports the proposition that both the operating and

13 Global externalities are thus differentiated from local externalities which result from the effects of a particular land use on a specific site. See Bossons, Reforming Planning in Ontario: Strengthening the Municipal Role (Ontario Economic Council, 1978), 25-8.

14 Such a tax could also be justified on allocative grounds, since it would cause the marginal social costs of private choices of development density to be taken more into account in such choices. However, its primary justification is on equity grounds, since other taxes may be used more efficiently to affect such choices, as may land use controls. Lot levies imposed at the time of development can have a greater impact on subdivision design. Were such taxes designed to encourage greater developed density, they would serve as an efficient 'density tax.' Land use controls may of course also serve this function; unfortunately, they have historically been used for the opposite purpose of requiring unnecessarily large setbacks and lot sizes.

capital costs of providing municipal services to residential property are inversely (but not linearly) related to density.[15] At the same time, since lower densities are generally (though not exclusively) found in newer suburban locations in which land values are lower, market values are on average directly related to density. As a result, the impact incidence of expenditure benefits is likely to differ substantially from that of a tax on residential properties levied in proportion to market values.

Taking into account both the absence of user charges and the desirability of imputing the costs of global externalities, it would be appropriate on equity grounds to classify residential property by zoning density designations and to specify different ratios of taxable assessment and assessed value in each zoning category.[16] Failure to do so implies taxing residents in higher-density areas to subsidize residents in low-density areas.

The purpose of the foregoing discussion is not to suggest that the property tax may be viewed exclusively as a tax which either is or should be distributed in accordance with the incidence of benefits provided by local government expenditures or of social costs. Such a view would be as incorrect as the contrary view that property taxes are or should be distributed exclusively in accordance with 'ability to pay.' Nevertheless, the property tax can be made to vary in ways which reflect differences in social costs generated by different uses of property, and such variation may (by relating taxes to benefits and/or to costs of externalities of given uses) result in a more equitable property tax.[17] Differences in bene-

15 Cf. Brazer, City Expenditures in the United States, Occasional Paper 66 (New York, National Bureau of Economic Research, 1959); Real Estate Research Corporation, The Costs of Sprawl: Detailed Cost Analyses (Washington, U.S. GPO, 1973); Downing and Gustely, Public Service Pricing and Urban Development: An Empirical Analysis of Fairfax County, Virginia, (Blacksburg, Va., Center for Urban Studies, Virginia Polytechnic Institute, 1976).

16 It is the characteristics of a locality (as reflected in average or permitted lot size) that are important to reflect in a 'density tax,' not property-specific density. I am indebted to John Tylee on this point.

17 Little empirical work has been done on this question. However, one empirical study (Price Waterhouse, 'Cost/benefit study of land use in the Borough of York,' 1971) concluded that marginal tax revenues from new high-rise apartment buildings approximately equalled additional expenditures entailed by such development. Since tax revenues were evaluated using the tax system then current, this conclusion implies that on benefit/cost grounds it is not 'unfair' to maintain the differential tax rates built into the current tax system.

fits of public services (and/or in the social costs of use-related externalities) should be reflected in property taxes where this can make the incidence of the entire tax/expenditure system more equitable.

In reforming the property tax the point is to obtain an equitable fiscal system, not an equitable property tax. Put differently, there are a variety of ways in which user charges and externality-compensating taxes may be incorporated in the municipal taxation system. If they are implemented separately, there is obviously no need to incorporate them into the property tax. It is necessary to reflect them in the property tax only if they are not implemented as separate taxes.

Separate implementation of user charges and externality-compensating taxes is desirable for several reasons. Perhaps most important, separation in this way helps clarify and communicate to citizens the basis on which taxes are collected and disseminates information on the cost of municipal services. Nevertheless, municipal councils have tended to avoid using existing powers to impose separate user charges through local assessments. Such reluctance may reflect difficulty in identifying beneficiaries, asymmetry in the redistributive impact of the resultant tax changes, or bureaucratic preference for avoiding a clear public identification of the costs of public works. It also reflects an unwillingness to 'change the rules' by using local assessments to pay for local capital improvements which have elsewhere been financed out of general tax revenues.

The tax as a reflection of ability to pay

While the property tax may in part be viewed as a substitute for user charges, a large component of the expenditures which it finances consists of local education costs, social services provided municipally, and other general services. Ideally, general services whose benefits cannot be clearly allocated to individuals should be paid for out of revenues raised by a general tax, levied in proportion to 'ability to pay.'

Few would claim that the property tax is as equitable as a general progressive income tax. A comprehensive income tax can (at least in principle) be equitable in the first two senses defined above; it can be defined in accordance with the criteria of horizontal and vertical equity as reflected in the notion of 'ability to pay.' Other general taxes in combination may also result in taxation in accordance with 'ability to pay'

criteria. However, the property tax cannot by itself be consistent with this definition of equity. Indeed, to assume that the market value of real property owned by an individual or corporation is a good proxy for ability to pay is naive.

To the extent that local property taxes are used to raise revenues to pay for general government services (local education spending being a good example), they should be regarded as a substitute for a better general tax. As such, they need to be evaluated in terms of how well the distribution of the property tax burden corresponds to taxpayers' ability to pay. As noted earlier, the property tax is used as a local tax primarily because of its identifiability and feasibility, and it cannot be expected to be as equitable a general tax as an income tax or a general (progressive) expenditure tax. Nevertheless, since it serves in part as a substitute for a general tax, a reduction in the extent to which its incidence diverges from that of a general income tax should be an important objective of property tax reform. This may be done either by changing the way in which property taxes are levied or by extending the current partial integration of property and income taxes that occurs through the Ontario property tax credit.

A warning to the reader is appropriate here. Some differences between the incidence of the property tax and the incidence of general ability-to-pay-based taxes should reflect user charges and/or social costs of use-related externalities. The discussion in this section deals only with the allocation of property taxes apart from 'special features' that serve as proxies for user charges and externalities.

In analysing the impact of any tax, it is necessary to differentiate between the impact incidence of the tax and its long-term incidence after allowing for the effects of changes in prices that result from the allocative consequences of behavioural adjustments to the tax. The long-term incidence of the property tax has been the subject of much dispute.[18] However, much of this discussion has centred on the incidence of a uniform property tax in a closed economy. In an open economy such as Ontario, any changes in the property tax will have no appreciable effect on re-

18 For a review, see Mieszkowski, 'The property tax: an excise tax or a profits tax?' Journal of Public Economics, April 1972; Bird and Slack, Residential Property Tax Relief in Ontario (University of Toronto Press for the Ontario Economic Council, 1978), chap. 3.

quired after-tax rates of return on investments, since capital is too mobile across provincial and national boundaries in the long term for the price of capital to be affected by changes in the demand for capital within Ontario. Consequently (assuming no change in capitalized benefits) the impact incidence of changes in the Ontario property tax will be largely capitalized in the market price of real property, while the long-term incidence of such changes will be dependent on changes in the rental price of real property resulting from the consequences for investment of changes in the ratios of market values to rental prices which follow from the capitalization of the impact incidence of the tax changes.[19]

In discussing the redistributive equity of the property tax, the remainder of this section will focus on the impact incidence of the tax as it applies to residential property. This reflects the fact that it is the impact incidence of any tax change which is of redistributive significance in the short run. The allocative effects of the tax, which may potentially lead to a different long-term incidence, will be discussed in a subsequent section, as will the relevance of the 'ability to pay' criterion in dealing with non-residential properties.

Ability to pay has been discussed fairly exhaustively in the public finance literature, most recently in the voluminous commentary on the analysis of the federal income tax system by the Carter Royal Commission on Taxation.[20] The concept may be summarized as follows:[21] a tax

19 The effects on residential rents in the long term may be summarized in terms of shifts in market demand and supply functions for residential housing. The impact of an increase in property taxes will in the short run be reflected in a lower ratio of market value to net rents (or to net imputed rents in the case of owner-occupied houses); this will result in a reduction in the number of houses which are profitable to build or maintain at any given level of market rentals. This supply reduction will potentially lead to higher rental prices in the longer run even under a relatively fixed demand in housing services. In regions where population growth causes continual increases in the demand for housing at given market prices, increases in market rents to reflect the higher taxes will occur more rapidly. These increases in rents may however be avoided or delayed if population mobility causes a lessening of population growth in regions or cities in which tax-induced rent increases are anticipated.

20 Report of the Royal Commission on Taxation (Ottawa, 1966, 6 vol.), especially Vol. 3, chap. 6 and 11. The underlying normative model is described in detail in Bossons, 'The value of a comprehensive tax base as a tax reform goal,' Journal of Law and Economics (1960) esp. 329-41.

21 This follows the model described in Bossons, ibid.

system which provides an equitable and neutral source of general tax revenues should be a mixture of a progressive tax on comprehensively defined incomes and a progressive tax on consumption expenditures plus wealth at death; the extent to which this mixture is weighted towards income taxes as opposed to taxes on consumption expenditures and wealth at death depends on the relative importance accorded to equity as against neutrality.

As a general tax, the property tax has serious deficiencies. It is not neutral. In particular, by imposing a tax which is specific to a particular factor (land and buildings), it alters the allocation of capital from what it would otherwise be, with attendant losses in efficiency. These distorting effects of the property tax, discussed below, mean that the tax is highly non-neutral. From an equity viewpoint, such non-neutrality is important because it is closely associated with deviations from horizontal equity.

The property tax has serious equity drawbacks as a general tax. Ability to pay, which is best measured by a comprehensive definition of income averaged over years, is not very closely correlated with property tax payments by homeowners. This correlation may most easily be examined by decomposing it into two components: the correlation of average incomes and average property tax payments for home-owning households grouped into income classes, and the correlation between deviations from these two averages within each income class. The first of these components has been analysed in a number of recent studies.[22] These studies show that the property tax by itself is quite sharply regressive, but that on average this regressivity is largely offset by the provincial property tax credit against income taxes. The second of these components has not been widely analysed, but there is little reason to expect the intra-class correlation between income and property taxes to be high.[23] What this implies is that, while the 'vertical equity' or average inter-class redistributive implications of the property tax may be neutralized by a property tax credit, the 'horizontal' equity of the property tax is inherently poor.

22 For a comprehensive review, see Bird and Slack, Residential Property Tax Relief in Ontario, chaps. 4, 5, and 7.

23 Such a conclusion is borne out by evidence on variation in property tax/income ratios within income classes provided by an Ontario Treasury Department study of a sample of individual property taxpayers in Guelph. Cf. Ministry of Treasury and Economics, Analysis of Income and Property Taxes in Guelph, 1972.

For tenant-occupied residential property, the incidence of the property tax is also not closely related to ability to pay. The incidence of the property tax on renters is more difficult to assess than for homeowners, since for rental property it is possible for the tax to be borne by the tenant, by the property owner, or by both.[24] The incidence of the tax will depend on market conditions; in areas and market segments where demand has been growing relatively rapidly, market rentals will at the margin cover all costs, including property taxes, so that the tax will be fully borne by tenants. However, where demand has not grown, property taxes (and particularly tax increases) may be partly or fully borne by landlords.[25] As a result of the variable incidence of the tax on rental property, the correlation between property taxes and ability to pay will be lower for tenants than for homeowners.

Even if the foregoing incidence problem were ignored by assuming all property taxes on rental property to be fully borne by tenants, the horizontal equity of the property tax as it applies to tenants and homeowners would on average still be poor unless property tax rates were differentiated according to the tenure status of the occupant. This is because, to be equitable on ability-to-pay grounds, the property tax should be proportional to average comprehensively defined income (or alternatively to expected average total consumption over a household's remaining life). On average, consumption of housing services will over most income ranges be approximately proportional to average total consumption, so that the rental value of housing services will on average be related to ability to pay. However, property taxes levied in proportion to market value will not be proportional to the rental value of housing services unless all such rents are capitalized by the market at uniform ratios of property values to rents. This implies that, for the property tax to accord with horizontal equity,

24 For a discussion of the literature on property tax incidence, see Bird and Slack, Residential Property Tax Relief. In discussing the incidence of the property tax in Ontario, capital must be assumed to be fully mobile, so that any tax increase is borne either by current owners or current and future tenants.

25 Demand for older apartments can fall while total demand for rental units rises. In markets where this occurs, one of the potential side-effects of imposing rent controls with cost pass-through is (by reducing the construction of new apartments) to increase the demand for old apartments and so cause a greater fraction of property tax increases to be passed on to tenants.

the ratio of property taxes to market values must differ between owner-occupied and rental properties so as to offset differences in market capitalization rates. At present, market capitalization rates are higher for owner-occupied residences than for rental properties.[26] This implies that effective tax rates (T/MV) for rental properties should be higher than on owner-occupied dwelling units in order to make ratios of taxes to rental values the same.

The point being made is highlighted in cases where rental buildings are converted to condominiums. Should property taxes on such residences change with conversion? Presumably the change in the form of tenure of occupants (from renters to owners) will not affect the nature of the building, its servicing requirements, or its use. In many cases the same occupants may remain as owners of the apartment they previously rented. Nevertheless, total market values of the property may rise on conversion, as has occurred in recent years. Is it then equitable for the taxes paid by those occupants to change, even where no change has occurred in the nature and use of the property or in the income or wealth of the occupants?

Because one of the more persistent criticisms of the current property tax system in Ontario is based on a mistaken belief that renters are overtaxed compared to homeowners, it is worth expanding on this point. Suppose we take two families of equal size, with adults and children of the same age in each family, and with identical wealth and income. Suppose the two families differ only in that one rents while the other owns the house in which it lives. Suppose the type and quality of accommodation are the same, as would be the case if they both lived in identical adjacent townhouses in a development partly built as a condominium and partly for rental. How do the two families differ in terms of criteria for taxation?[27]

26 The 'capitalization rate' is the ratio of the market value of an asset to the rental price charged for the use of the asset. Differences in capitalization rates are induced by a number of factors. These include differential income tax treatment of inflation-induced nominal capital gains (such gains, though not real, are taxed on rental property but not owner-occupied property). They also include differential investment risk arising from the greater opportunities for control of risk available to owner-occupiers. Both these factors cause the required investment rate of return on owner-occupied property to be lower than on rental property, resulting in higher equilibrium ratios of property values to rentals for owner-occupied property.

27 Total comprehensive-base income and wealth for each of the two families were assumed identical. In this case, differences in the market value

The point of this example is of course that the market value of a property will differ depending on whether it is owner-occupied or rented, even though the ability to pay of owners and tenants may be identical. As has been noted, this difference arises for a number of reasons, including risk differentials and the differential tax treatment of inflation-induced capital gains on owner-occupied and rental housing, and is a phenomenon that can be expected to persist in a long-run equilibrium.[28] The generally higher value of owner-occupied housing as a ratio to market rental value means that if properties are taxed in proportion to their market values, a family that owns its home will pay more property tax than a second family which rents, even where the two families are of equal size, age, and wealth and where their houses are identical.

The preceding discussion has analysed the equity of the property tax, considered independently of other taxes. I now analyse the extent to which it may offset defects in other taxes.

In actuality, no income tax system is perfectly equitable, and no expenditure/estate tax system is perfectly neutral. It is therefore necessary in designing a tax system to obtain a 'second best' in which necessary departures from optimality are offset, or at least nearly so. The current income tax system in Canada provides many examples. In this context, the role of the property tax has to be considered in the light of whether it offsets or accentuates ways in which the current income tax system diverges from neutrality or from an ability-to-pay definition of equity.

There are two important defects in the current Canadian general tax system for which the property tax may provide a crude offset. One of these is the failure of the income tax to include imputed rental income on owner-occupied residences in the definition of taxable income. The second is the undertaxation of estates and bequests. Though the property tax provides only a crude offset to these defects, that at least yields some support for its use as a source of general tax revenue.

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of housing used by the two families do not serve as a proxy either for differences in total income or differences in wealth. Also, since the use and location of the properties are identical, there are no differences in potential user charges or externality-compensating taxes.

28 For a review of other factors underlying the differential demand for owner-occupied as compared to tenant-occupied housing, see Bossons, 'Housing demand and household wealth: evidence for homeowners,' in Bourne and Hitchcock, eds, Urban Housing Markets: New Directions in Research and Policy (University of Toronto Press, 1978, 86-106).

Nevertheless, the property tax is not a very effective compensatory instrument for either the non-taxation of imputed net rental income of owner-occupants or the undertaxation of estates. A more effective means of offsetting the non-taxation of homeowners' imputed rent would be to allow the deduction of a fraction of rental payments by residential tenants and the deduction of mortgage interest and property taxes by homeowners.[29] The effect of providing both a net rental deduction for tenants and the deductibility of mortgage interest and property taxes by homeowners would be to make the income tax relatively neutral in its treatment of tenants vs homeowners.[30] In doing so, however, a different form of nonneutrality would be enhanced, since this technique for eliminating the current subsidy of homeowners implies subsidizing all forms of housing consumption, thus leaving a residual subsidy of investment in residential structures (whether owner-occupied or rental) as a result of the consequent tax-exempt status of net rents.[31]

The property tax is a relatively poor instrument to use as an offset to

29 According to U.S. data provided in Goode, The Individual Income Tax (Brookings Institution, 1964, 123), it would be appropriate to allow the deduction of 40 per cent of residential rental payments; this would be approximately equivalent to the fraction of gross rents not accounted for by interest and property taxes deductible by the renter. For a further discussion, see Bossons, 'The value of a comprehensive tax base as a tax reform goal,' 342-4.

30 This move to neutrality in the tax treatment of residential rents would of course leave untouched the additional tax subsidy of home-ownership resulting from the tax-exempt status of capital gains on owner-occupied residences. However, because most of this subsidy results from the tax capital gains on other assets, it would be largely removed by providing for the indexation of capital gains on other assets. Proposals to this end are described in Bossons, 'Implementing capital gains tax reforms,' Canadian Tax Journal 27 (1979) 145-56. By restricting taxed capital gains on all assets to changes in real values (measured in dollars of constant purchasing power), indexation of capital gains would limit the average capital gains tax subsidy of investments in owner-occupied homes to the tax that would otherwise be imposed on the expected change in the average relative price of such homes. In the long term, assuming indexation of capital gains on other assets for tax purposes, the expected annual rate of change in real housing prices is unlikely to be large, presuming a relatively slow growth in the real cost of newly constructed housing.

31 Whether the subsidy of tenant rentals resulted in lower housing costs for tenants would depend on whether the subsidy was shifted to owners

the current non-taxability under the income tax of imputed net rentals on owner-occupied homes. At best its impact is proportional to gross rents rather than net rents, making such an offset discriminatory against younger home-owning households for whom net rentals are on average a relatively low fraction of imputed gross rents.[32]

The property tax has sometimes been viewed as a form of wealth tax, and as such it might be thought to be a potential offset to the under-taxation of estates in the Canadian tax system. However, this view ignores the fact that the property tax is an asset tax, not a wealth tax, and would result in overtaxation of younger homeowning households with a high leverage of investments in housing assets. Beyond this, the distortions implied by taxing only a specific type of asset are substantial, with a material efficiency loss potentially resulting from the restriction of the tax to only one form of investment.

All in all, the property tax is neither a good proxy for the ability to pay nor a particularly effective offset to defects in the current general system of taxation of income and wealth. This does not gainsay its usefulness as a municipal tax, since its identifiability and easy differentiability across municipalities are important advantages. Nevertheless, the property tax has significant disadvantages as a general tax, so that it is important to restrict its use as a means of financing general expenditures, assuming some better alternative is available and will be used.[33]

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through price increases caused by subsidy-induced increases in demand. It is likely that there would be significant shifting of the subsidy to owners of rental property in the short run and in the absence of rent controls.

32 This is because the market value of residential property reflects the capitalized value of expected future rentals gross of interest. A property tax based on a property owner's investment equity in a residence would be a better offset to the tax exemption of net imputed rental income. The optimal offset is different in Canada than in the United States since mortgage interest and property taxes are deductible for income tax purposes in the United States. A property tax on owner-occupied homes would have become a more effective offset to the income tax exemption of imputed net rentals on owner-occupied homes if the recent proposals of the federal Conservative Party for income tax credits to reflect mortgage interest and property taxes had been enacted in legislation.

33 From this viewpoint, it is unfortunate that the provincial government has in recent years chosen to pursue a policy of shifting the burden

3 EQUITY CONSIDERATIONS FOR TAXES ON NON-RESIDENTIAL PROPERTIES

So far I have discussed the application of principles of equity to the taxation of residential properties. We turn now to property used for non-residential purposes.[34] The chief complication in dealing with non-residential property is that the incidence of the tax is harder to specify than it is for taxes on residential property. For residential property, the tax is borne by the consumer of housing services, by the investors providing capital, or by the owners of land. In the case of homeowners, the consumer, investor, and landowner are the same person. For taxes on non-residential property, by contrast, the incidence of the tax is potentially much more complex, since the tax may also be shifted to other factors of production (in particular to employees) or to consumers of the goods and services produced on the property.

User charges and externalities

As with residential properties, the differential incidence among the owners of non-residential properties of the benefits of municipal expenditures may provide a reason for incorporating user charges into municipal taxes on such properties. Within any class of property, it would be coincidence if the present value of the expected benefits to be derived from current or future municipal services were to be uniformly proportional to the market value of properties in that class.[35] Consequently, the equity of a property tax on non-residential properties may be improved either by fin-

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of paying for education expenditures to municipal property taxes by reducing the real (constant-dollar) magnitude of provincial grants to municipalities.

34 The discussion is framed in terms of the effects of the municipal property tax. The same points apply to the municipal business tax, which is in effect a varying surtax on the property tax.

35 In the absence of externalities, one whould expect the difference in market value between two otherwise identical properties to be equal to the capitalized value of the effect on market rents of any differences in property-specific benefits of municipal expenditures. However, the total market value of any property will naturally also depend on the factors held constant in the foregoing statement, so that the capitalized value of benefits of municipal expenditures will be correlated with actual property-specific benefits.

ancing property-specific benefits out of user charges that are directly related to such benefits or by incorporating such user charges into the property tax. Without implementing a more extensive set of separate user charges, this would be achieved at least in part by making the ratio of taxable assessment to assessed market value vary with property characteristics that are related to the incidence of property-specific benefits. The extent to which the equity of the property tax on non-residential properties could be improved by incorporating such user charges is an empirical question which is not easily answered.[36] Nevertheless, some hypotheses may be stated. For example, it is probable that both capital and operating costs of municipal services provided to industrial property are inversely related to density, but that market values of such properties are directly related to density. This implies that making taxes on industrial property uniformly proportional to market values would cause overtaxation of higher-density industry located in older areas outside the central core of urban centres, compared with taxation of lower-density industry in newer suburban locations. Similar overtaxation would result for central-core industrial properties if not offset by the congestion externalities associated with such properties. Assuming that implementation of substantive market value assessment would imply tax increases for older industrial areas, the tax increase would in this context be inequitable whether or not fully capitalized.

While it is likely that the costs of services directly allocable to particular properties will differ among types of non-industrial commercial property, there is insufficient empirical evidence to permit such differences to be related to differences in market values for non-industrial commercial properties. In general, higher servicing costs per square foot are associated with higher rental and market values per square foot, so that it is difficult to formulate reasonable hypotheses about ways in which the ratio of capitalized benefits to market values may vary. However, turning from property-specific benefits to potential externalities, it is possible to make

36 Unfortunately, there is very little empirical evidence available on the costs or benefits of municipal expenditures on services to non-residential property. Consequently, the relevance of the potential desirability of user charges in this context is as a possible rationalization for variations in the ratio of taxable assessment to market values for such properties and as an indication of need for empirical research on this subject.

some fairly clear statements. Because of the substantial capital and operating costs of transportation servicing regional commercial, retail, and office land uses, there are substantial negative global externalities associated with such land uses. On the assumption that such externalities are a more rapidly increasing function of commercial density than are market values, it would be appropriate to impose a 'density tax' on areas zoned for higher commercial density. Some empirical evidence exists to suggest that this assumption may be valid in large metropolitan areas.[37]

The foregoing discussion may be summarized as follows. There is a rationale for arguing (as a first approximation) that a property tax based on assessed market values may serve as a reasonable proxy for user charges for property-related municipal services which benefit non-residential properties, at least within particular classes of non-residential property. However, it is necessary to reflect differences between classes of properties (both in type and general location) in order to obtain an equitable relationship between the allocation of the costs of such services and the property taxes raised to pay for them. Beyond this there may be a valid argument for a supplementary 'density tax' to reflect the social costs of negative externalities associated with central-city locations in large metropolitan areas.

Such claims obviously do not apply to that portion of property taxes on non-residential properties which pay for general expenditures not of direct benefit to property, such as social services. Since general expenditures should be financed out of taxes based on ability to pay, it is necessary also to evaluate the property tax on non-residential properties as a general tax.

General taxes on non-residential property

The property tax is less satisfactory as a general tax when levied on non-residential properties than when levied on residential properties. The demand for consumption of housing services will cause ownership and/or rental values of residential property to be at least somewhat related to household ability to pay, even though (as pointed out above) this relation-

37 See Clayton Research Associates Limited, Municipal Finances and the City of Toronto's Inner Core Area, report prepared for City of Toronto Planning Board, 1975.

ship is not close. For non-residential property owners, however, there is no similar reason to assume even an approximate relationship between property market value and owners' ability to pay.

From an ability-to-pay viewpoint, a tax on non-residential property must be evaluated in terms of how closely it is related to the ability to pay of the individuals who directly or indirectly bear the tax.[38] Moreover, in determining who bears the tax, it is necessary to take into account whether (and how quickly) the tax is shifted to customers or workers of the firm using the taxed property. The possibility of such shifting will vary substantially from firm to firm, depending on the structure of both the factor markets and the product markets in which the firm operates.

Taxes on industrial property which are in excess of the property-specific benefits of municipal expenditures are likely to be subject to considerable tax-shifting, particularly to workers through lower wage increases in the middle term and to owners of residential properties in the longer term. Where an individual municipality levies taxes on industrial uses which are higher than in neighbouring municipalities, such taxes will tend to depress local wages by causing some firms to relocate elsewhere or by discouraging new firms from establishing plants in the municipality.[39] Where taxes on industrial uses are increased throughout a region (e.g. uniformly throughout Ontario), the same type of effects will occur but at a slower pace, since the locational choices of firms will be more sensitive to differences between neighbouring municipalities than to interregional differences. In both cases, the property tax on industrial employers will in part be borne by workers in the form of lower wages. Whether the property tax is progressive or regressive in this instance depends on the extent of the tax-shifting to employees and on the relationship between plant value and employee income across employers. The incidence of the property tax on industrial property is at best randomly related to ability to pay; the

38 Taxes on businesses or corporations must be allocated to the people (whether shareholders, owners, customers, or workers) who pay the tax; corporations are in this respect merely intermediaries. Cf. Report of the Royal Commission on Taxation, Vol 4, chap. 19.

39 It is of course possible that wage decreases do not occur because workers move to other municipalities where jobs are better-paying. Such moves are less costly (relative to income) for higher-skilled workers, so that the extent to which intermunicipal tax differentials are shifted to workers is likely to be greater for low-skilled workers than for high-skilled workers.

most likely pattern of its incidence on workers is regressive.

Taxes on commercial property used for retail purposes may be shifted both to consumers (through higher retailing markups) and to employees. The extent to which such shifting occurs will depend in large part on the relative mobility of consumers, employees, and retail firms and on the rate of growth of demand in the local retail market in each district within the municipality.[40] Under current circumstances it is likely that in most Ontario municipalities a substantial part of property taxes in excess of the property-specific benefits of municipal expenditures are shifted to consumers in the form of higher prices on consumer goods.

Taxes on commercial offices in major urban centres are less likely to be shifted to employees and more likely to be shifted to the customers of firms than is the case for industrial employers, assuming a lesser locational mobility of prime office uses and a relatively inelastic supply of professional and managerial employees.

When applied to non-residential property, the current municipal property tax has considerable defects. Some portion of such property taxes can be justified on the basis either of paying for property-specific benefits or of compensating for global externalities. However, the remainder cannot be justified on ability-to-pay grounds, since its incidence is at best randomly related to ability to pay and (particularly in the case of taxes on industrial property and local retailing areas) probably even perverse. Lowering property taxes on industrial property and on local retail property should have one of the highest priorities in property tax reform.

4 THE EQUITY OF A CLASSIFIED ASSESSMENT SCHEME

We have seen that an equitable property tax must take into account a number of factors other than the market values of properties. A tax levied as a uniform proportion of market values will not be equitable. However, some of the crucial additional factors are common to particular types of property. Therefore, a logical next step is to analyse whether property can be divided into classes within which equity may be reasonably

40 In older local retail centres with low or negative rates of growth in demand, it is likely that the incidence of tax increases will be primarily on local businessmen and property owners and only secondarily on customers and employees.

approximated by taxes that are proportional to market value. Two questions need to be answered: Are the discrepancies between an equitable tax and a tax which is uniformly proportional to market value for all property primarily the result of differences between property types? If so, how can properties be classified to minimize the remaining discrepancies?

An additional reason for examining a classified property tax is that it is the easiest way of implementing what I have termed 'administrative market value assessment.' Indeed, a type of classified assessment scheme is now being implemented for some municipalities in Ontario under Section 86 of the Assessment Act, motivated primarily by a need to deal with the growing administrative problems of the current property tax system.[41]

The administrative advantages of a classified assessment scheme are set out first. The equity of a classified property tax is then evaluated both as a means of charging benefits to users and as reflecting ability to pay. The size of classes, a critical factor, is discussed in the final subsection.

The administrative case for a classified scheme

The assessment of properties is potentially subject to a number of problems. Those problems arise in the appraisal of market value (especially with unusual properties that are not often sold), the minimization of tax avoidance in mixed-use properties where total appraised value must be allocated among uses subject to tax at different effective tax rates, the minimization of avoidable appeals, and the prevention of political manipulation of assessment procedures. These problems are enhanced in the current property tax system in Ontario, which is in practice a system of classified assessment though in law classifications are not recognized as such. They are compounded by public misunderstanding and uncertainties because taxpayers are given inadequate information about assessments.

The administrative problems now facing assessors, municipal officials, and taxpayers would be greatly reduced by moving to a system of 'administrative market value assessment' in which the classified assessment structure employed in practice is recognized in law. Such a reform could

41 The problems, along with the particular tax changes being implemented by the Province's using the powers provided by Section 86, are evaluated in Section 7.

be implemented in several ways, depending on how variations in the effective tax rates were built into a new property tax system. Provincial legislation would have to provide for provincial or municipal definition of variations in ratios of taxes to appraised values, as well as defining how properties are to be appraised. The law should also require that taxpayers be informed on assessment notices of the appraised value of their property as well as taxable assessment. 'Appraised value' would be the market value of a property at a specified benchmark date.[42]

Variations in ratios of taxes to appraised values may be implemented either by varying the mill rates (in which case taxable assessment should be set equal to appraised value) or by varying the ratio of taxable assessment to appraised value (in which case the mill rate might well be uniform within a municipality). If municipalities were freely able to determine such variations at any time (and thus free to vary them from year to year), then there would be no advantage to introducing taxable assessment as a variable distinct from appraised value; indeed, in such a situation taxpayer understanding would be best served by focusing attention on variations in mill rates defined in relation to appraised value. However, where municipal authority is constrained (as it now is in Ontario) to preclude municipal councils from changing the relative burden of property taxes on different types of property, there is some advantage to making a clear distinction between what is determined municipally and what is determined provincially. This may be done by using the mill rate (T/TA) as a 'municipal' variable and the ratio of taxable assessment to appraised value as a 'provincial' variable.

The desirability of allowing municipalities to vary ratios of taxes to appraised values across property classes will be discussed later. At a minimum, municipal authority to change relative effective tax rates across properties should be limited. Given this, it is convenient to maintain the distinction between mill rates and the taxable assessment/appraised value ratio, using the latter to define variations in effective tax rates across

42 For administrative reasons, the benchmark date would have to be prior to the preparation of the assessment roll, so that appraised values could not be expected to necessarily be equal to current market values. To reduce administrative costs, benchmark values might only be changed every few years (e.g. every three years) rather than annually. Legislation should specify the frequency with which benchmark values are changed.

properties. This procedure has several advantages. First, it helps clarify for citizens the distribution of responsibility between provincial and municipal governments. Second, the effects of annual budget decisions that determine the municipal mill rate are more clearly separated from longer-term decisions about how property taxes are distributed across classes. Third, provincial constraints on municipal ability to change the distribution of property taxes across property classes may be implemented more efficiently.[43] In the rest of this report it will therefore be assumed that variations in effective tax rates are best accomplished by varying taxable assessment/appraised value ratios.

Following this approach, administrative market value assessment would require a legislative specification (either by the Province or separately by each municipality) of how taxable assessment would be calculated for each property once the appraised value was determined. In the simplest case the ratio of taxable assessment to appraised value would vary across classes of properties but would be fixed for all properties within a class. However, this ratio might also vary within classes, as long as the variation was based on easily measurable attributes of a property and was explicitly defined in legislation.[44] Where properties were classified for purposes of computing taxable assessment or where taxable assessment was also based on property attributes other than assessed value, the property class and other attributes used should also be reported to the taxpayer on assessment notices.

A crucial feature of this administrative reform is that the ratio of taxable assessment to appraised value would depend only on objectively

43 At the limit, such constraints may (as at present) preclude any municipal action to change relative effective tax rates across properties. In this case, ratios of taxable assessment to appraised value would be set by the Province for each class of property, and municipal authority would be limited to the annual determination of a uniform mill rate applied to all taxable assessment. While it is unnecessarily rigid to maintain this extreme position, there are strong reasons for limiting the ability of municipal authorities to change the relationships between effective tax rates for different property classes. The optimal extent of such constraints, together with procedures to implement them, are discussed in Section 6.

44 Property type, front footage, and zoning designation are examples of additional attributes on which taxable assessment conceivably might be based. If such additional variables were used, it would be necessary for there to be an explicit specification (e.g. by provincial order-in-council or municipal by-law) of how the ratio of taxable assessment to assessed value would be determined, given the additional variables.

determined attributes of a property, so that all questions of judgment would be confined to the determination of appraised value. Accordingly, the grounds for assessment appeal would be limited to invalid measurement or identification of objective attributes underlying the ratio of taxable assessment to appraised value, or to incorrect appraisal of market value as of the benchmark date. Being legislatively specified, the ratio of taxable assessment to appraised value would not be subject to appeal.[45]

One important aspect of administrative reform is that taxpayers could be clearly informed about how their taxable assessment was calculated. In particular, the taxpayer ought to be informed of the appraised value of a property as well as the taxable assessment. Since appraised value would approximate actual market value on a specified date, the taxpayer could fairly easily decide whether the assessment was reasonable. The calculation of taxable assessment given the appraised value of the property would then also be a straightforward calculation easily checked by the taxpayer.[46] Under the present system, by contrast, the taxpayer is told only the taxable assessment of a property, but not the underlying appraised value or the normal ratio of assessment to appraised value for comparable properties. The improvement in taxpayer understanding that would result from better information and a clearer definition of taxable assessment is a strong reason for administrative reform.

Classified assessment as a basis for user charges

On both residential and non-residential property, the property tax can be a fairly equitable method of financing the provision of property-related municipal services. Such services include both property-specific services

45 This assumes that the legislation specifying how the taxable assessment/appraised value ratio is to be determined is within the powers of the legislature. If such legislation is in the form of a municipal by-law, the by-law would have to be consistent with the nature of the delegated authority defined by provincial statute, and might of course be subject to legal challenge on grounds of inconsistency with such delegated authority.

46 To facilitate this, the assessment notice should state the appraised market value, the ratio of taxable assessment to appraised value, property class and any other property attributes on which this ratio depends, and taxable assessment. The notice should also include a brief definition of terms that specify the benchmark date at which market values are assessed.

(such as water supply, sewer access, and garbage disposal) and services of a public-good nature for which demand may be attributed to localities and property types. Where possible, property-specific services should be paid for through direct user charges. However, where separate charges are inefficient or undesirable, the property tax should be modified to provide for variations in ratios of taxes to market values that serve to approximate the effects of the 'missing' user charges. In addition, the property tax can be a device for collecting additional taxes from properties whose uses generate negative externalities of a global nature, that is, the extra costs of the additional municipal services (especially transit and highways) required by such uses.

In a classified property tax, the costs of providing property-specific services or those allocable to negative externalities would be allocated to properties by making property taxes a uniform proportion of market value within each class.[47] The tax rate for each class should be determined by estimating the aggregate costs of property-related services allocable to properties within that class and then dividing that total by the aggregate market value of such properties. A classified property tax thus could be an equitable means of paying for the costs of property-related services to the extent that the ratios of property value of the costs allocable to each property are uniform within the classes.

For residential property, a substantial amount of the likely variation in the costs of providing property-related municipal services can be ascribed to differences in location and to differences in the number of residential units per building.

It will be assumed that, within a local area and for a given type of building, the benefits of expenditures on property-related services not financed by direct user charges are at least approximately related to the rental value of housing services provided by a property (imputed rents in the case of homeowners). On this assumption, the costs of property-related services could be financed equitably through a property tax in which the ratio of tax to market value varied by locality and by property type.

47 There is no reason why property taxes could not be any simple function of market values within each class. In particular, a linear function with a non-zero intercept could yield a better approximation to the true relationship between costs of property-related services allocable to particular properties and the market values of such properties within each class.

Variations by property type should reflect differences between types in the average ratio of property market values to imputed or market rentals; they should also reflect differences in the aggregate costs of servicing different types of residential units with the same rental value. The differences in ratios of property values to rentals would imply a higher ratio of tax to property market value for rental property than for owner-occupied property.

In most urban areas there is a substantial degree of homogeneity of lot shape, building form, density, and other characteristics of land use for buildings of a particular type within local neighbourhoods. Consequently, a substantial fraction of the variation in ratios of service costs to imputed or market rents is attributable to variations between the averages of such ratios for buildings aggregated by type within local neighbourhoods. Provided that classes are small enough to yield a high degree of homogeneity within each class, a classified property tax can provide a reasonable approximation to the package of user charges and externality-compensating taxes that would be most equitable.

If anything, there is an even stronger case to be made for a classified property tax as a means of financing the cost of property-related services allocable to non-residential property. As with residential property, it is necessary to consider location and property type in defining classes. The case for the equity of a classified property tax is stronger for commercial property than for industrial property, primarily because of the greater difficulty of defining homogeneous classes of industrial property. Indeed, certain types of industrial property (e.g. a steel mill) may be unusual enough to require a single property to be a class by itself. But the bulk of non-residential properties may be divided into classes within which there is substantial homogeneity.

A classified property tax and ability to pay

Municipal expenditures on education, social services, and other services that are not 'property-related' should be financed by a general tax that is at least approximately related to ability to pay. The use of the property tax to finance these general expenditures is much less satisfactory, and its defects as a general tax are intrinsic. Reforms can be devised that would make the property tax an equitable means of financing property-related

services, but nothing can make it a fair way to support education and social services. This use of the property tax should at least be restricted to taxes on residential property; if applied to non-residential property, the incidence of a property tax not offset by property-specific benefits is not acceptably related to ability to pay.

For residential property the best feasible approximation to ability to pay is probably a tax proportional to the rental value of housing services consumed. Such a tax diverges from the equitable ideal to the extent that current housing consumption varies across households when expressed as a ratio of the average level of the total consumption each household expects to be able to sustain over its lifetime. Significant variations in this ratio between households is likely, but there is no easy way of improving on the equity of a residential property tax made proportional to the imputed or market rental price of the housing services provided by each property.[48]

One important advantage of a classified property tax is that differences within a municipality in the ratios of market values to imputed or market rental prices will usually be confined to differences between classes of residential property. Differences in ratios of market values to current rental prices occur for either of two reasons. First, they may arise because of differences in the expected future rate of growth of real rental prices for different classes of property. Second, they may arise because of differences in the discount rates implicitly applied to expected future rentals by prospective buyers. The former can cause value/rental ratios to vary across classes of property defined by locality and type but are unlikely to be reflected in differences within such classes. The latter are unlikely to arise except between types of properties, since they result largely from differences in income tax treatment and in perceived investment risk.

How detailed should a classification be?

The clearest case where market value data can be used to make the pro-

48 This statement is of course true only for a property tax viewed in isolation. The equity of the property used to pay for general expenditures could be substantially improved by fully integrating it with the income tax; in this case, the local property tax would become simply a withholding tax for a local income tax collected by higher levels of government.

perty tax more equitable is in the taxation of highly comparable properties where market transactions are frequent. The taxation of residential property can be improved by using market value information to ensure that two neighbouring properties are taxed fairly. In this very restricted application of market value information we may assume that, within a local residential neighbourhood in which properties are at least relatively homogeneous, property taxes would be levied equitably if made proportional to market values. Although this does not necessarily mean that property taxes should (on property of the same type in a local neighbourhood) be made proportional to market value - there are other considerations, including investment disincentive effects, that need to be considered - market values do provide a clear, unambiguous, and generally accepted basis for defining 'fair' property taxes within a narrowly defined class of properties.

The primary advantage of using market values to define assessment is that it provides an 'objective' criterion by which assessments may be compared. Properties are most comparable if they are of the same type and are near one another. Accordingly differences in assessment for comparable properties within a neighbourhood will generally be accepted as 'fair' if proportional to differences in market value.

To achieve horizontal equity in the treatment of neighbouring properties of the same type, any system of classification will do. However, the two aspects of vertical equity can be achieved only if the classification is fine enough to distinguish both type and location.

There are a number of ways in which residential property may be classified. In addition to location, these include (1) whether single-family or multiple-unit, (2) by zoning designation of property, (3) by number of units if multiple-unit, and (4) whether owner-occupied. The first three characteristics are density-related and may be used as proxies for area and property characteristics related to the cost differentials in providing property-related services or to the generation of negative global externalities. Using the fourth characteristic to define classes allows the ratio of taxable assessment to market value to differ with the tenure status of occupants in order to reflect differences in average ratios of market values to imputable rents. A further classification of properties by area (e.g. separately for each assessment district within a municipality) would make the first three characteristics more effective as proxies for servicing cost differentials and

for externality costs.[49]

The use of a relatively fine system of classification would enable taxes to be proportional to market value within each class. At the same time it would allow average ratios of taxes to market values in each class to be set at levels which differ between classes in a way that is consistent with the equity precepts advanced earlier.

One of the main reasons why differences in market value can be used to improve the equity of the property tax for residential property in a particular class located in a relatively small neighbourhood is that most residential neighbourhoods are relatively homogeneous with respect to factors that affect user charges or to externality effects that should be incorporated in the property tax. In addition, rent/value ratios may be assumed to be relatively uniform within a neighbourhood for each property type.

For commercial and industrial property, it would be necessary to adopt a somewhat different approach to classification. In that case it would be desirable to differentiate primarily between types of properties, classifying properties by use, zoning, and size. Uses to be differentiated should include (1) industrial uses, (2) local retail uses, (3) regional retail uses, and (4) commercial offices.[50] Classifying by size would make possible a distinction between regional shopping centres, older small-scale commercial retail strip developments, small-scale office buildings, and large office buildings.[51] Except possibly to distinguish properties in the central business districts of larger urban areas, location need normally not be used as a classifying variable.

A reform that reflected such concerns might proceed in two steps. First, equalize market value/assessment ratios for properties within small and relatively homogeneous classes, postponing until later the question whether the market value/assessment ratio in each class is correctly related

49 If districts are used, it would be appropriate to aggregate them where necessary to obtain areas of a reasonable size (say with a population of 10 000 or more).

50 Perhaps it may also be desirable to distinguish different types of industrial uses in order to allow for differences in externalities that have identifiable impacts on municipal expenditures.

51 For example, the City of Toronto's proposals for property tax reform propose distinguishing between commercial properties both by building height and by total non-residential floor space. Zoning designations could also be used as a means of distinguishing between types of commercial districts.

to the ratio for other classes. (This step is what has earlier been termed 'administrative market value assessment.') Second, evaluate whether differences between classes in the ratios of assessment to market value reflect the equity considerations discussed above. Where they do not, the assessment/market value ratios should be altered as necessary.

5 ECONOMIC AND ADMINISTRATIVE EFFECTS OF A CLASSIFIED SCHEME

No tax change (or any other government decision) can be evaluated solely on equity grounds. Differences in effective property tax rates will have economic effects (on investment) that in turn may affect the attainment of social objectives. Other factors to be taken into account include the potential use of property tax rates as an adjunct to land use planning and the administrative problems implicit in the assessment of 'market value'. These issues will be evaluated in primarily static terms for a system that is in place. The problems created by the costs of tax changes themselves will be discussed later.

Allocative effects of the property tax

As already noted, the property tax is far from neutral, so that a number of choices are distorted from what they would be in the absence of a tax. These distortions include effects on the nature of investments in structures, on the allocation of capital between structures and other capital assets, and on the spatial distribution of investments in structures.[52]

An important effect of the property tax is its impact on choices among alternative building types. As is shown elsewhere, the property tax provides an incentive for building designs to be modified so that buildings of less durability (and higher maintenance costs) are constructed than would occur in the absence of the tax.[53] Even in the absence of externalities

52 For a more extended discussion of these effects, see the companion piece by Michael Denny in this volume.

53 Arnott and Young, 'The property tax as a tax on durability,' Canadian Journal of Economics 12 (1979) 485-93. This effect is an implication of the fact that the property tax is in equilibrium a tax on the capitalized value of net rental profits. In practice, this effect is likely to be enhanced by administrative assessment practices.

associated with durability, the effect of the property tax in encouraging less durable construction would be a clear case of social inefficiency. Since in fact there are often positive local externalities associated with durability, the allocative effects of the property tax are actually perverse, in that they accentuate a divergence from optimal allocation that is already generated by private markets.

Because the property tax is imposed on a specific type of capital, it provides a disincentive for the investment in that particular type of asset and so (in the long term) will result in a decrease in the supply of that particular capital asset. This effect is clear in the case of a tax change in Ontario, since such a change will not affect the required after-tax return on capital. The impact of any change in the property tax will be capitalized in the present value of expected future net rental income gross of interest on borrowed capital.[54] The result is a change in the ratio of this present value to investment costs, resulting in a decrease in the number of profitable investments. As a consequence of the effective independence of capital market net rates of return from any property tax changes that might occur in Ontario, the allocative effect of any increase in Ontario property taxes will be a reallocation of investment funds to uses outside the province or to other forms of capital assets not affected by the tax increase.

Beyond this, a change in the property tax may have important effects on the spatial distribution of investments. Such effects would arise where the tax changes are different ratios of expected future net rentals (gross of interest) in different parts of an urban area and so would change the present value of incremental future expected net rentals per dollar of investment costs for marginal investment.[55]

Any change in the excise taxes implicitly levied on different investments must of course be evaluated in a 'second best' context, in that a tax-induced change in the allocation of investment funds may imply an improvement or deterioration in the allocation of capital depending on whether the differential excise offsets or exacerbates social costs not re-

54 It may be noted that the Modigliani-Miller theorem is applicable in this context because of the low bankruptcy risk associated with mortgage loans. Cf. Stiglitz, 'On the irrelevance of corporate financial policy,' American Economic Review, December 1974.

55 It is assumed that any change in the property tax affects net rentals derived from new investments, as is the case under the current Ontario property tax.

flected in private decisions. In this regard, any discussion of allocative effects must deal with the externality problems discussed earlier. Where (as is now the case) there are important global externalities associated with different forms of development, the property tax may provide the most effective vehicle for incorporating 'user charges' that encourage forms of investment which have fewer negative global externalities. From this viewpoint there is a close relationship between desirable allocative effects and the perceived equity of the property tax, in that a more accurate reflection of the social costs attributable to particular land uses will also imply disincentives for uses with above-average social costs.

The use of the property tax as a planning tool

The considerations just discussed are elements of a broader point, namely, that there are a variety of reasons why it may be desirable for a government to intervene to cause land uses to differ from what they might otherwise be. There is no reason why such intervention should not include differential taxation that penalizes 'undesirable' land uses and subsidizes 'desirable' land uses. Indeed, municipal or provincial intervention in private land use decisions is likely to be more efficient if it can be implemented with a wider variety of tools.[56]

The use of property tax differentials as a means of implementing municipal planning policies has been given little consideration in previous discussions of property tax reform. Nevertheless, where particular land uses are to be encouraged or discouraged, variations in effective property tax rates can be a powerful means of effecting such objectives. For example, property tax reductions on industrial property can encourage industrial development. Furthermore, the externality-compensating taxes advocated earlier on equity grounds are by definition desirable on planning grounds.

Some provisions in the current Assessment Act and in recent provincial or municipal proposals reflect land use planning considerations that imply that it is desirable to encourage the maintenance of certain types of

56 For a discussion of the rationale underlying such intervention and of the effect on the social efficiency of intervention of constraints on the use of instruments for intervention, see Bossons, Reforming Planning in Ontario (note 13 above), especially chapters 2 and 8.

land uses. For example, the desirability of maintaining existing farmland in farm uses and of preserving historical buildings and private open space in urban areas can be reflected in property taxes by appraising the value of such lands in their current use along with their current market value; taxes may then be levied on the appraised value of the land in current use.[57] Where this is done, the differential between such amounts and the taxes which would have been accrued if the property were appraised at market value should be accumulated (along with interest) and charged to the property if the use is changed.[58]

There has been a tradition of inhibiting municipal use of taxing powers as an instrument for intervening in land use decisions.[59] In part, this tradition reflects a wish to avoid the undesirable effects of inter-municipal competition and a wish to avoid uncertainty about future tax rates, which would be created by allowing municipalities to vary tax rates imposed on different classes of property. The latter concern is of particular importance in minimizing the disincentive effects of property taxes for investments in maintenance and new buildings.

Rather than prohibiting variations in tax rates as at present, it would be better to allow municipalities to pass by-laws changing the ratio of taxable assessment to appraised value for classes of property but to subject such by-laws to the same requirements of notice, confirmation, and right of appeal to the Ontario Municipal Board as apply to zoning by-laws. These requirements would both protect individual rights against arbitrary tax changes and inhibit changes in the distribution of taxes between property classes because municipalities would have to justify such changes before an impartial forum.[60]

In this way municipalities could vary effective tax rates through the adoption of a deliberate taxing policy by a step quite separate from the

57 This manner of appraisal is prescribed for farm land by Section 27(3) of the Assessment Act.

58 A provision to this effect is applied to golf courses by Section 31 of the Assessment Act.

59 This tradition is reflected in the Municipal Act in Sections 504 and 506, which require municipalities to levy taxes using a single mill rate on real property and business assessments.

60 For a more extensive discussion of such procedural safeguards, see Bossons, Reforming Planning in Ontario, Sections 4.2, 6.3, 6.4, and 8.2. As noted below, it may be preferable to have such hearings conducted by hearing officers appointed by the Minister of Revenue.

annual setting of a mill rate. The mill rate would continue to be applied uniformly to taxable assessment; changes in tax policy would be effected through by-laws amending taxable assessment/appraised value ratios.

In providing for hearings by the Ontario Municipal Board or by provincial officers on objections to municipal by-laws amending assessment/appraised value ratios, the legislation should state that the Board shall have regard for criteria generally applicable to planning by-laws.[61] In addition, the Board should be required to consider the resulting differences in taxes on comparable properties in the municipality and in adjacent municipalities.

Assessment and administrative problems

The implementation of even administrative market value is not easy or straightforward. Because many properties are unique and transactions may be infrequent in certain classes of property, it is not a trivial problem to assess market value for properties that have not recently been sold. This problem is exacerbated by biases introduced by the functioning of the Assessment Review Court, which tends to place the burden of proof on the assessor to justify an assessment of an unusual property. Risk-averse assessors thus tend to be conservative in assessing such properties, since their credibility as assessors is undermined by successful appeals against their decisions. The consequence is a predictably lower ratio of assessed market value to actual market value for unusual untraded properties.

In assessing commercial property, particularly where neighbouring properties are rarely bought and sold, there is a natural tendency to assess property by capitalizing rentals obtained from current uses rather than to assess the value of property if redeveloped. In fact, the actual market value of a property may (particularly in metropolitan centres) depend primarily on its redevelopment potential. However, the greater difficulty of 'proving' potential value will tend to cause assessments to understate actual market value in cases where the potential redeveloped value exceeds value in current use.

In certain cases (such as the assessment of vacant land and parking lots), the bias toward understatement of development potential may be

61 Cf. ibid., 126-7, 180-1.

sufficiently serious to warrant compensatory variation in ratios of taxable assessment to assessed market value. Such compensating variation is easily implemented in a classified assessment scheme. More generally, the biases inherent in administrative assessment procedures need to be recognized and allowed for.

Assessment of government property

The taxation of government property provides for transfers from other governments to municipalities that compensate for municipal costs created by the uses of such property. It is consequently useful to divide government property into two categories: offices and other facilities required for general government purposes, and property (such as parkland) which is a local public good. Because the former could (for the most part) be rented from private owners or released for alternative private uses without changing the provision of local public services, such property should be taxed as if it were subject to the alternative private uses permitted by local land use regulations. Such taxation, besides allowing more accurate costing of general government services, would reflect the fact that government offices and facilities generate demands for municipal property-related services.

Government property that is primarily used to provide local public services should be treated differently from general government property. Reflecting its effect in reducing aggregate demand for local public services, such property might well be subject to a negative tax. For example, parkland within a municipality but owned by another government relieves that municipality of the expense of at least part of the aggregate demand for public recreation facilities. At a minimum, such property should be exempt from tax as long as it is maintained in its current use.

An alternative way of obtaining essentially the same result would be to specify that government-owned property be assessed at its value in current use. This would imply taxation of government offices on the same basis as commercial offices, but it would ensure that uses with no commercial rental value would in practice be exempt from tax. For simplicity, local parks and schools should be defined as having no rental value.

Without differentiating as above between the two types of government property, perverse intergovernmental transfers can be generated, parti-

cularly in two-tier regional municipalities.[62] Moreover, since the values of local public goods are at least partially capitalized in the market values of neighbouring properties, taxing properties used to provide local public goods necessarily introduces some double taxation.

6 THE COST OF UNANTICIPATED TAX CHANGES

The economic effects discussed above ignored the cost of introducing tax changes. If they are not anticipated before their announcement or implementation, such changes can hurt previous investments. The economic effects of consequent adjustments by investors therefore must be examined.

Unanticipated tax changes have an equity dimension as well. By causing changes in the market values of property, they cause capital gains or losses that would otherwise not have occurred and are thus the equivalent of one-time wealth taxes.

In a property tax system in which assessments and taxes are tied to market values, unanticipated tax changes can occur not only as a result of tax reform but also as a result of changes in property values, which can occur quickly (especially in smaller neighbourhoods). Besides examining the transitional problem of implementing a tax reform, therefore, we must also look at the social, economic, and political problems created by the sudden changes in effective tax rates that can occur for particular classes of property in a classified tax system once it is established.

To cope with the problems created by tax changes, we must do three things. We must ensure that unanticipated tax changes do not occur arbitrarily without an explicit political decision. This can for the most part be accomplished by a classified assessment scheme in which classes are numerous and changes in market values are used only to redistribute taxes within each class. Second, we must ensure that the temporary costs of any deliberate changes are mitigated by transitional provisions; a phase-in period would provide for this. Third, we have to establish safeguards for affected taxpayers. Since transitional provisions can only partly ameliorate the redistributions of wealth caused by tax changes, procedural

62 An example is High Park in the City of Toronto, which would revert to the estate of John Howard if not maintained as a city park but on which a significant tax would have been payable to the upper-level Metro government by the City under the original government market value assessment proposals.

safeguards can help ensure that tax changes are accepted as fair.

The effect of tax capitalization

The redistributive transfers caused by changing a tax are a potential source of inequities. The future tax liabilities resulting from the property tax, being relatively easy for investors to predict, are reflected in the current market values of property. Changing the property tax will thus cause market values to change, thus creating capital gains for owners of property on which future taxes will be increased. In effect, any tax change has two components: a set of redistributive transfers of wealth from those who lose to those who gain, and the change in subsequent yearly tax payments defined by the change in tax law. There are thus necessarily two aspects of equity that must be evaluated: Are the transitional wealth transfers equitable or desirable on other grounds? Secondly once those have occurred, is the revised tax system more equitable than the one it replaced?

I have argued that the answer to the second question is not obvious and that making property taxes proportional to market value will introduce inequities if done uniformly for all classes of property. I intend now to argue that the transitional capital gains and losses induced by any tax change are inherently inequitable and are justified only if balanced by sufficient social gains from the tax change. This should not be regarded as a rationalization for avoiding change, but rather as a complication which must be taken into account in designing reform.

There is an old public finance maxim that 'an old tax is a good tax.' Like most maxims, it is only partly correct. Nevertheless, it is true that taxes are at least partly capitalized in market values, that the benefits of low taxes were obtained by previous owners, and that most current owners other than the aged have paid additional amounts for the property in order to reflect the market's assessment of the discounted present value of expected future tax savings.[63] To the extent that current owners have paid

63 On theoretical grounds, one would expect expected future property taxes to be fully capitalized in market values if other variables are held constant. The available Canadian empirical evidence on this question is mixed; it also suffers from the difficulty of not being able to identify the effects of property taxes separately from the incidence of expenditure benefits and from other variables. Cf. Wales

more for their properties to reflect expected future tax savings, they do not gain any economic benefit from the savings.

Tax reform, by eliminating the tax saving, lowers the market value of their properties. Where property owners purchased their properties at prices that capitalized current taxes, the capital loss is not offset even retrospectively by any tax saving which was to their benefit.

In light of the unsettled state of provincial tax reform, current market values may to some extent already reflect the possibility of substantive market value assessment. Obviously, the impact of tax capitalization depends on expectations regarding the level of future taxes. Unfortunately, governmental statements announcing the abandonment of reform initiatives have likely had a greater influence on expectations than is warranted, given the administrative need for reform. Although the possibility of market value assessment may have affected market values in the mid-1970s, it was probably heavily discounted even then because taxpayers did not know the consequences of the reforms being proposed.[64]

On equity grounds, it is clearly advantageous to minimize transitional capital gains and losses. Further, the potential benefits of redistributing taxes between classes should outweigh the inequities of the arbitrary wealth changes they would induce. It is not enough for tax redistributions to be of social benefit; the benefit must be large enough to offset the social cost of the change itself. At a minimum, it is necessary to design transitional provisions which reduce arbitrary wealth redistribution.

The easiest way is to phase in the tax reform over a period of years.[65] All changes in assessment that would result from implementation

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and Wiens, 'Capitalization of residential property taxes,' Review of Economics and Statistics 56 (1974), 329-33; Chinloy, 'Effective property tax rates and tax capitalization,' Canadian Journal of Economics 11 (1978) 740-50. When differential expenditure benefits are incorporated in empirical tests, the observed degree of capitalization increases, indicating the importance of expenditure benefit identification. Cf. Oates, 'The effects of property taxes and local public spending on property values,' Journal of Political Economy 81 (1969) 957-71, and subsequent comments.

64 Some evidence for this statement is provided by the surge in assessment appeals in 1978 following publication by the government of detailed information on average assessment/market value ratios by class of property for many municipalities.

65 Municipalities may now implement a limited phase-in using powers set out in Section 505 of the Municipal Act. However, the phase-in period

of reform (whether positive or negative) would be introduced gradually over a period of years. For example, assuming a ten-year phase-in, 10 per cent of the change would occur in the first year and a further 10 per cent in each of the succeeding nine years, so that it would be only after ten years that implementation of the change would be complete. Such a phasing has two desirable effects: it reduces the arbitrary redistributions of wealth resulting from the capitalization of reform, and it reduces any financing problems that may occur for taxpayers facing significant tax increases. The second is more important. A phase-in is of particular importance in moderating the impact of tax reform on cash flow for households and small businesses that may be subject to capital rationing.

Effects on urban stability

Changes in the property tax can have important allocative effects by affecting investments in new buildings, maintenance, and renovation. Problems for urban stability arise in cases where unanticipated tax increases cannot be shifted (even in the long run), where such tax increases make it no longer profitable to continue existing land uses, and where the resulting propensity to disinvest is manifested as a lack of maintenance. Because of the importance of investments in maintenance and renovation in affecting the character of urban neighbourhoods, any change in such investments can lead to neighbourhood changes that in turn affect the economic attractiveness of further investment. The effects on investment of tax changes thus need to be analysed carefully.

Such negative feedback potentially occurs in situations where tax reform goes beyond administrative market value assessment (using a finely classified assessment scheme with no changes in average taxes in each class) to impose greater uniformity in average effective tax rates across classes. The magnitude of potentially negative effects will be greatest in municipalities where movements to uniformity cause the greatest changes in average taxes in particular neighbourhoods. The larger the municipality, the greater the likelihood of this occurring.

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is limited to five years and may only apply where a tax increase resulting from reassessment exceeds $50. It would be desirable to allow a longer phase-in period and also to implement the phase-in in terms of taxable assessment rather than taxes.

One of the main redistributive effects of the original proposals for property tax reform would have been a substantial increase in taxes on owner-occupied homes in Metro Toronto, particularly in inner-city neighbourhoods in the City of Toronto. This tax increase would have had a potentially significant disincentive effect on investment in owner-occupied houses in some of these neighbourhoods, creating a danger of an increased likelihood of blight and decay in these neighbourhoods.[66] Because such blight would at first occur very slowly, this danger would not be immediately visible. Nevertheless, its long-term potential importance is material.

This danger is obviously a potential cost that needs to be set against any benefits obtained by shifting property taxes between classes. Similar social costs may arise from the effects on older retail areas of increases in taxes in such areas. Indeed, such areas are, in many municipalities, more marginal than inner-city residential neighbourhoods and so more subject to visible blight and property abandonment.[67]

To counter this potentially negative side-effect of property tax reform, it would be appropriate to introduce some offsetting subsidy of investments in maintenance and renovation. One way of doing so for residential property would be to exempt from taxation those improvements made by the current owner to residential properties that do not increase the number of dwelling units. This would mean that increases in market value resulting from such improvements would not be included in taxable assessment until the property is sold or ownership otherwise transferred. A similar exemption could apply to small retail stores.

Potential enhancements of effects of speculation

A further side-effect of tying property to market values is that neighbourhood social stability may be reduced by the effect on property taxes of

66 Areas where this effect would be of particular concern include the area east of Yonge Street between Eglinton and the Mt Pleasant cemetery, the College/Lansdowne area, and other areas south of College St and west of Spadina. See Figure 4 in Interim Report, Joint Committee on Property Tax Reform, June 1979. Some other areas would face property tax increases whose effects would be more than offset by likely growth in market demand.

67 This is a potential problem in a number of small towns in Ontario as well as in larger cities, primarily as a result of increased competition from neighbouring regional centres.

speculation in land. An increase in market values in a neighbourhood resulting from speculation in possible redevelopment will, with market value assessment, result in an increase in property taxes which is specific to that neighbourhood. This tax increase will increase the perceived cost of remaining in the neighbourhood and hence encourage existing residents to sell and move. This will be enhanced by any liquidity problems caused by increased cash outlays on property taxes.

Whether decreased stability is desirable is of course a two-sided question. Speculators in most contexts may be regarded as performing a valuable economic function through increasing the speed of market adjustments to changes in demand. However, for this arbitrage function to be unambiguously desirable, it is necessary to assume that there are no social costs to change. Unfortunately, social costs are likely to be associated with land use changes. This is because neighbourhood roots have value both to residents and to society; the destabilization of neighbourhoods may create problems of alienation at the personal level, break up social and political networks, reduce the perceived value to individuals of political participation, and increase the cost of political organization. While such effects are intangible, they are not unimportant.

The desirable and undesirable effects of speculation may be at least partially separated by noting that the major 'social problem' engendered by increased property values under a market-value-based assessment scheme is the result of tax payments increasing relative to incomes for owner-occupants. This increase can cause equity problems through the effects of capital rationing and in the process can contribute to undesirable instability in a neighbourhood.[68] This problem can be mitigated by distinguishing between tax accruals and tax payments. The two types of property owners most likely to be subject to capital rationing are homeowners and small retail businesses owning the premises they occupy. For each of these classes of taxpayer, legislation could provide for an automatic deferral of the difference between currently accrued taxes and the taxes that would have been accrued if assessments had not increased in relative terms. A deferral provision of this sort is proposed in this paper; it would prevent the occurrence of unpredicted changes in property tax payments arising

68 The main reason for capital rationing is the effect of restrictions on ratios of carrying costs to income to which borrowing is implicitly or explicitly subject.

from changes in relative property values within a property class.

The fixed mill rate problem

In moving to a system in which property tax assessments are more closely linked to market values, it is important to ensure that property taxes are not automatically increased when property values rise. There is a tendency - best illustrated by the 1976-78 experience in California - for mill rates to be held constant when property values rise, thus causing an 'automatic' increase in property taxes.[69] Michael Denny, in his companion paper in this volume, suggests that this may have occurred in the Peel Region after the introduction of market value assessment.[70] Clearly, it is necessary to try to insulate property tax from sudden shifts that may be caused by sharp changes in market values.

It should be noted that the problem is not simply one of dealing with situations where all property values change in the same proportion. The more important problem arises when some types of properties increase significantly in relative value, thus causing taxes on such properties to be increased even if total property tax revenues stay unchanged. This can lead to arbitrary redistributions of tax burden from one class of property to another.

It would be clearly desirable to inhibit such sudden changes in assessment. It is no accident that the California Proposition 13 'taxpayers' revolt' occurred following the large 1976-8 increases in property taxes on owner-occupied homes. Beyond this, inhibiting sudden shifts in taxes would also help avoid the potential neighbourhood destabilizing effects of sudden tax changes noted above.

To deal with this problem, it is necessary to find some device that slows down the speed with which taxes or taxable assessments are changed when relative property values change or that eliminates any automatic coupling of taxes to property value changes. The problem, primarily one

69 The effect of this in many jurisdictions in California (e.g. Los Angeles County) was an approximate doubling of property taxes on owner-occupied homes in a three-year period. Municipal revenues and expenditures did not grow at this rate, since property values rose at a much slower rate for other types of property.

70 Whether this is true is a debatable matter, since any tax increase which occurred in Peel Region at this time may also be attributed to the increased administrative costs resulting from the simultaneous introduction of a two-tier regional government.

of unanticipated redistributions of property taxes between detailed classes of property, may be easily handled in a classified property tax if classes are numerous enough. In this case, property values need only be used to distribute taxes within each class; changes in the aggregate taxes on property in a class need be changed in response to changes in relative prices only if the tax changes are otherwise appropriate.

It is of great importance to ensure that average property taxes for a particular class of property are not automatically changed by changes in average property values for the class. Tax changes should be evaluated on their merits and adopted by legislative action. Accordingly, they should be subject to the same procedural safeguards and transitional provisions as any other tax change legislated by a municipality.

Procedures for dealing with tax changes

The classified property tax described in Section 4 can provide the framework for establishing procedures within which tax changes can be effectively evaluated and implemented. The objectives are, first, to ensure that the economic costs and potential transitional inequities are taken into account and, second, to allow sufficient flexibility for taxes to be changed when appropriate. The procedure that allows for change must not make it too easy.

A classified assessment scheme with a large number of classes can effectively be used to implement administrative reform and horizontal equity within classes while at the same time eliminating tax shifts between classes. With this structure it is easy to ensure that any changes in aggregate taxes raised from each property class occur only by explicit political decision. This can be done by providing that market value information is otherwise used only to change the distribution of property taxes within classes and not to change aggregate taxes paid by each class.

For the redistribution of aggregate taxes between property classes, legislation should establish a procedure for changes in ratios of taxable assessment to market values (or in mill rates) applicable to particular classes. Such a procedure should include an evaluation of the equity considerations and economic effects of the change. It should be similar to that used for changes in municipal land use controls, which entail similar problems.[71]

71 See Bossons, Reforming Municipal Planning in Ontario, chaps. 2-3.

To the extent that the equity of the property tax is improved by making variations in effective tax rates for each class a better reflection of the differentiated costs of providing municipal services, such improvements are unlikely to be accomplished by province-wide reforms. The cost differentials may well vary from municipality to municipality, as will their significance. Accordingly, it is necessary to establish a process for improving the equity of the property tax for specific municipalities.

In doing so, it is useful to allow for such changes to be initiated either by the provincial government or by municipal by-laws and to provide that in either case there should be a forum in which conflicts over facts or the predicted consequences of a change may be resolved. And it should be possible for interested parties other than the provincial government and the municipality for which a change is proposed to have objections heard.

This may be done by allowing either the Ministry of Revenue or a municipal council to propose changes in the ratios of taxable assessment to appraised value for different classes of property in the municipality, including changes in the definition of classes, and by allowing public examination of such proposals. A hearing agency should be established to hear objections to the proposed changes.[72] Legislation should ensure that such hearings be advertised and set down the criteria that the hearing agency should consider in making recommendations. The role of the hearing agency should be to make recommendations to the Minister of Revenue, subject to concurrence by the council of the municipality for which the changes are proposed.[73] A final decision approving or rejecting the recommendations should be made by the minister.

The foregoing process can accommodate changes proposed to implement

72 The Ontario Municipal Board might be designated in legislation as the hearing agency. Alternatively, the Ministry of Revenue might be required to appoint special hearings officers to conduct such hearings. In either case, proceedings should be subject to procedural rules that afford rights of 'natural justice' to affected parties. For a review of such rules and of the need to implement such rules in a quasi-judicial process, see Bossons, Reforming Municipal Planning in Ontario, 50-5.

73 Where a change proposed by the Ministry of Revenue would apply to a group of municipalities, the requirement for municipal concurrence should be satisfied if approved by the councils of more than half of the affected municipalities, provided that the approving municipalities contain more than half of the total population of the affected municipalities.

municipal or provincial planning policies as well as to improve equity. Accordingly, the criteria by which the hearing agency and the minister should evaluate proposals to change assessment/appraised value ratios should be defined in legislation to include the following:

¶ the relationship of differences among the resulting effective tax rates on properties in different classes to the differential costs of providing municipal services to such properties;
¶ other factors affecting the equity of the resulting effective tax rates;
¶ the consistency of the resulting effective tax rates with established provincial policies and with municipal planning policies adopted as part of regional or local official plans; and
¶ the relationship of the resulting effective tax rates on properties within the affected municipality to effective tax rates on comparable properties in neighbouring municipalities.

The application of these criteria would be facilitated if the property tax were divided into two separate components for which different assessment/appraised value ratios could be defined, since the first criterion would apply only to the 'property service tax' component.

The proposed process would involve no delegation of final authority by the Province, since decision-making powers would remain with the Minister of Revenue. However, by allowing municipal initiation of changes and establishing a review process for proposals, it would encourage greater municipal participation in tax reform. Effective tax rates would be clarified by an explicit examination of all the effects of such changes.

7 THE CURRENT ONTARIO PROPERTY TAX SYSTEM

The current Ontario property tax system is a makeshift one in which there are substantial discrepancies between legislatively specified 'ideals' and actual practice. Through a combination of changes resulting from assessment appeals and an optional municipal reassessment procedure implemented in 1979, the system is being transformed into a classified property tax.

The emerging classified property tax differs in several ways from that discussed above. On the one hand classes are defined in broader terms, resulting in a much smaller number of classes and a consequent inability to

reflect equity considerations that imply desirable differences between classes in average assessment/market value ratios. On the other hand there has been no attempt to rationalize the differences between classes that result from municipality-initiated reassessment. Such differences follow inconsistent patterns across municipalities and should not be left as the final product of 'reform'.

The nature of the current assessment system

Property assessments in Ontario are not made on a uniform basis. For historical reasons properties of different types and ages are assessed in different ways. Nominally, assessments are uniformly based on market value.[74] In practice, however, there have been wide departures from what is specified by law. They have arisen for a number of reasons: difficulties in assessing infrequently traded properties, delays of assessment revisions, and assessment procedures that have not accurately reflected variations in market values. In particular, replacement cost was widely used as a basis for appraisal by municipal assessors before the takeover of the assessment function by the Province in 1970.

The differences between assessment and market value have persisted since 1970 because of a provincial decision to freeze assessments at their 1970 values pending the long-postponed implementation of property tax reform.[75] A major bias in the pre-1970 system, which resulted from the

74 This nominal system is specified by Section 27 of the Assessment Act (R.S.O. 1970, C.32, as amended), which states that with the exception of farmland all properties shall be assessed at market value, which is defined in the Act as 'The amount that the land might be expected to realize if sold in the open market by a willing seller to a willing buyer'. Farmland is to be assessed at its value for farming purposes.

75 This has been done by yearly legislative enactments since 1970 of amendments to Section 86(1) of the Assessment Act to provide that assessments made by provincial assessors shall remain at their values of the previous year except as changed to reflect the construction, demolition, or alteration of buildings during the year. The additional assessments resulting from construction or renovation are determined after inspection of premises for which building permits have been obtained. The additional assessments for new buildings are the product of their appraised market value (or selling price, if sold) and the average ratio of taxable assessments to appraised market values for property of that type in the municipality; for renovations, the additional assessment is derived in the same fashion except that appraised value is based on estimated construction cost, quality of finishing, and an allowance for potential market discount of the value

widespread use of replacement cost in appraisal, was a growing discrepancy between assessments on newly constructed or renovated buildings and assessments on older, unaltered buildings. Since buildings of a given age tend to be grouped together in municipalities, this bias has led to substantial divergencies between such areas in effective tax rates on market value.

The post-1970 freeze on assessments is qualified in legislation by the additional provision in Section 86(1) that an assessor may modify the value of an assessment to the extent necessary to make the assessment equitable with respect to the assessment of similar real property in the vicinity. Such modification is not mandatory, and the post-1970 practice of provincial assessors has been to leave the determination of such 'inequities' up to the assessment review process in response to appeals by taxpayers. A similar provision in Section 90(1) of the Assessment Act provides that assessment review tribunals may, in response to an appeal, modify assessments to make them equitable with respect to the assessment of similar neighbouring properties. This provision has been interpreted by the courts to mean that appealed assessments will be modified to bring the ratio of assessment to market value for a property on which an assessment has been appealed down to the average of such ratios for similar property in a municipality regardless of the basis of the original assessment.[76]

As part of the tax reform review process, extensive data were published in 1978 on the average assessment/market value ratios of highly aggregated classes of property in each municipality in Ontario. This information has been used in a growing number of successful appeals by taxpayers. The surge in appeals has both increased administrative costs and effected a material redistribution of taxes.

The redistribution resulting from appeals has been both arbitrary and regressive in its overall impact, though warranted in specific cases. Because such appeals are property-specific, they necessarily introduce inequities vis-à-vis other properties whose assessments have not been appealed. Since such appeals are worth undertaking only where the ex-

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of new construction when added to an already-depreciated house of older vintage.

76 See for example Foxhead Inn Limited v. Regional Assessment Commissioner for Niagara, Municipal and Planning Law Reports 2 (1977) 66-71. 'Similar real property in the vicinity' has been interpreted by the courts to imply comparisons to average assessment/market value ratios for all property generally used for the same purpose in the municipality.

pected tax reductions are sufficient to warrant investing in the cost of an appeal, they have been made primarily by owners of larger properties with above-average assessment/value ratios.[77] Moreover, the appeals have redistributed taxes across classes as well as within classes. Because the cost/benefit ratio for instigating an appeal has been too large for most homeowners or owners of smaller commercial property, a smaller fraction of aggregate assessments in such classes has been successfully appealed than in other classes where average assessments per property are larger. Since the appeal process reduces aggregate assessments, compensatory increases in mill rates have redistributed taxes to homeowners and to owners of small commercial property.

Current differences between classes

The extent to which the ratios of property taxes to market values differ among property types at present is shown in Tables 1 and 2 for Toronto and four smaller Ontario cities. (Mill rates are uniform across classes within each municipality, so that Tables 1 and 2 also show the variance in effective tax on market value.) Out-of-date market values are used, and changes in market values since 1975 have caused some changes in relative market prices in all five municipalities.[78]

Median ratios and weighted averages are both shown in Table 1; the latter is simply the ratio of aggregate assessment to total estimated market value of all properties in each class. As may be noted, there is a systematic tendency to underassess smaller properties in the current system, reflected in the fact that the median ratio is less than the average for all classes in the table. This is of particular importance in the case of non-residential properties, where the range of property sizes (and values) is

77 The process of appeal of the amount of an assessment has two or three steps, depending on the amount of the assessment in question. First, an assessment is appealed to the Assessment Review Court. A decision of the Assessment Review Court may then be appealed by either the taxpayer or the municipality. In the case of assessments over $50 000, an appeal may be made directly to the Ontario Municipal Board. For smaller assessments (including most single-family residences), an appeal must be made first to a county judge and then from that decision to the Ontario Municipal Board.

78 The use of 1975 values reflects the fact that 'market value assessment' would have been implemented using 1975 values prior to 1980. The Ministry of Revenue is now revising appraised values to reflect 1978 values.

TABLE 1

Current assessment as a percentage of 1975 market value, City of Toronto

	Median ratio for properties in class	Weighted average
Residential properties:		
1-2 units	8.1%	8.3%
3-6 units	9.4	10.6
More than 6 units	21.6	21.7
Commercial	12.6	22.3
Industrial	24.5	28.4
Vacant land	7.3	15.7
Exempt property	15.1	20.7
Utilities and railroads	13.1	18.7

NOTE: Residential properties are not classified by tenure of occupant.
SOURCE: Assessment Division, Ministry of Revenue. Reproduced from Interim Report of the Joint Committee on Property Tax Reform, City of Toronto, June 1979.

TABLE 2

Ratio of 1978 taxable assessment to 1975 market value, cities of Kitchener, Cambridge, Timmins and Hamilton

	Kitchener	Cambridge	Timmins	Hamilton
Farm land	0.117	0.210		0.087
Residential property:			0.133	
1-2 dwelling units	0.118			0.105
3-6 dwelling units	0.221	0.190		0.154
7 or more dwelling units	0.286	0.356	0.184	0.255
Commercial property	0.187	0.233	0.203	0.169
Industrial property	0.227	0.286	0.223	0.194
Property assessed as a pipeline	0.221	0.210	0.361	0.157

SOURCE: Ontario Gazette, Vol. 112:7, 17 Feb. 1979; March, 1979

greater. It is also reflected in the differential assessment of residential properties with more than six dwelling units.

In the case of commercial properties, the substantial difference between median and average assessment/market value ratios reflects a number of factors: the higher average age of smaller commercial structures, a systematic tendency to underassess properties in local retail strips, and a lower average ratio of rents to market values for smaller properties. A major part of the differential thus arises from sources that are closely related to a differential that was adduced as desirable on equity grounds in the previous section; namely, a lower effective tax rate on smaller commercial properties outside the central core.

Interestingly, the clearest inter-class 'inequity' in the current property tax system within the City of Toronto would appear to be the relatively high taxation of industrial property. As noted earlier, it is difficult to rationalize property taxes on industrial properties that are in excess of the approximate value of benefits allocable to such properties from municipal expenditures. Current property taxes on industrial property (at least in the City of Toronto) appear to be substantially in excess of amounts that can thus be rationalized.[79]

A somewhat similar pattern of differences exists in Table 2. In all cases assessments are a lower fraction of market value for single-family dwelling units and duplexes. This category includes rented residential property as well as owner-occupied homes, but is predominantly the latter. Differences among other classes vary a little from the Toronto pattern. Industrial property is not so dramatically overassessed compared to other non-residential property as it is in Toronto. Moreover, in three of the four municipalities shown in Table 2, larger multi-unit apartment buildings are assessed at a higher ratio to market value than any other class of property shown.

We may conclude, first, that there are substantial variations between classes in assessment/market value ratios in the current system and, second, that these variations are similar but not identical across municipalities. The current system is in practice a classified property tax, but

79 In addition to the above-average effective tax rates shown in Table 1, industrial properties are subject to a 'business tax' surcharge, which for most industrial properties is 60 per cent of the property tax. By contrast, most central-core commercial uses (other than premises of financial institutions) are subject to surtaxes of 30-50 per cent.

one in which neither the classifications nor the differences between classes are based on a clearly conceptualized model of assessment equity. Such a model has been set out in this paper, and it may be used to develop an equitable classified assessment scheme. A number of the differentials in the existing scheme may well be consistent with equity, but that is a result of coincidence rather than design.

Current procedures for administrative reform

The Ontario property tax system is becoming a classified property tax through two processes of reform. The first is the appeal process described earlier; each successful appeal eliminates discrepancies between assessment/market value ratios for particular properties and municipal average values of this ratio for arbitrarily defined classes. The second is an optional municipal-initiated reassessment, provision for which is set out in a 1979 amendment to Section 86 of the Assessment Act. This amendment, introduced after the government announced that it would not proceed with market value assessment, allows the implementation of a classified assessment scheme in which the aggregate assessment of each class remains unchanged but assessments within a class are made proportional to the estimated 1975 or 1978 market value.[80]

A classified assessment scheme legislated for all municipalities in the province would make it possible to resolve the problems now created by the combination of systematic departures of taxable assessments from market values and court-directed reassessment to market values for specific properties. If varying ratios of taxable assessment to market values can be specified legislatively, the current systematic variations across classes in class averages for such ratios may (if desirable) be maintained. At the same time, assessment criteria and the role of the courts in assessment appeals would be clarified.

Administrative market value assessment would as a by-product eliminate the reason for most current assessment appeals. The classified assessment scheme which may be implemented under the provisions of Section

80 Section 86(3) provides that such reassessment may be undertaken by the Minister of Revenue if so requested by resolution of the council of a municipality, and provides that classes shall be prescribed by the minister. Estimated 1975 market values were used as the basis for reassessment made in 1979; 1978 values are used in 1980 reassessments.

86(3) would eliminate all cases where ratios of assessment to market value deviate from the average for classes defined by the minister; appeals would consequently become limited (presuming the continued existence of Section 90) to cases where the minister's definition of a class is rejected by the courts or where the provincial appraisal of market value is contested by the taxpayer. Confining the appeal process to its rightful function of reviewing the accuracy of appraisals is one important benefit of implementing a classified assessment scheme.

Four cities with populations over 40 000 (Kitchener, Cambridge, Timmins, and Hamilton) and ten other municipalities initiated such within-class reassessment in 1978 for taxation in 1979.[81] For this purpose, all properties in each municipality were divided into between 3 and 7 classes.[82] Vacant land other than farmland was allocated to classes corresponding to the zoning designation applicable to the property. Average ratios of assessment to appraised market value in each of the four larger cities reassessed have already been presented in Table 2.

The reassessments initiated under Section 86 of the Assessment Act are a form of the 'administrative market value assessment' defined at the beginning of this paper. They clearly do not represent substantive reform. As Table 2 indicates, the reassessments leave substantial differences between classes in average ratios of assessment to appraised value. Moreover, the relationships between average ratios are substantially different even in neighbouring cities. For example, the resulting ratio of assessment to appraised value for multi-unit buildings (more than six units) would be 2.4 times as high as for single-family houses in Kitchener but only 1.8 times as high in Cambridge, though they are both part of the same regional municipality. There is little reason to expect relative servicing costs and implicit externality-compensating taxes to rationalize this difference; the primary justification for this kind of reassessment under Section 86 is to eliminate assessment appeals.

81 The populations of the four larger cities, based on 1978 municipal enumeration, were as follows: Kitchener, 135 000, Cambridge 73 000, Timmins 44 000 and Hamilton 308 000. Kitchener, Cambridge, and four of the other reassessed municipalities are lower-tier municipalities in the Regional Municipality of Waterloo.

82 The classes are specified for each of the fourteen municipalities in Ontario Regulations 82/79 and 133/79, made 1 February 1979 and 1 March 1979 respectively, and are shown in Table 2 for the four cities.

At the same time, there are substantial potential shifts between groups of properties within some of the classes used in the three cities.[83] For residential property, the importance of shifts within classes varied from city to city. For example, within the '1-2 dwelling unit' class in Kitchener, average assessment/appraisal ratios were increased for older residential properties and decreased for newer houses. Houses built before 1900 experienced an average tax increase of 14 per cent; those built after 1971 had on average a 9 per cent decrease. By contrast, in Hamilton an analysis of average residential tax shifts by ward indicated no clear-cut pattern, though there was some tendency for older houses to experience tax decreases and newer houses tax increases.

For commercial properties, the most important shift within a class resulted from sharp increases in taxes on vacant land. It is also likely that, within the 'commercial property' class, average assessment/appraised value ratios may have been increased for older small retail establishments and decreased for regional shopping centres, but this proposition could be not be tested with the available tabulations. Such a shift would have been undesirable on equity grounds since the previous differences probably reflected differential servicing costs and/or externality-compensating taxes.

As an attempt to implement 'administrative market value assessment,' the current use of Section 86 is subject to two major criticisms: that classes are too large (i.e. that there are too few classes), and that there are no transitional provisions. The number of classes is too small to allow either for differences between subclasses that may potentially reflect differences in relative servicing costs or for externality-compensating taxes.[84] The lack of transitional provisions means that there is nothing to mitigate the undesirable inequities resulting from the transfers of wealth resulting from market capitalization of reassessment-induced tax changes. It would be preferable to modify Section 86 reassessments to provide more classes and

83 The following summary is based on analyses by the Municipal Finance Branch of the Ministry of Treasury and Economics. I am indebted to L.J. Close for providing information on the results of these analyses.

84 There is in principle no reason why existing differentials in ratios of assessment to appraised value should necessarily reflect differentials that may be desirable on the equity grounds previously discussed. However, it is likely (if only because of historical fluctuations in the relative price of energy) that older commercial and residential property is developed at a greater density than more recently developed property and so should properly be subject to lower effective tax rates.

to implement transitional provisions.[85]

8 HOW THE ONTARIO PROPERTY TAX SHOULD BE REFORMED

Some kind of property tax reform is urgently needed in Ontario. The problems created by the chaotic state of the Ontario property tax have not disappeared with the 1978 announcement of the abandonment of the government's proposals for substantive reform. The procedure established by the enactment of Section 86(3) of the Assessment Act has provided a safety valve for the worst municipal pressures, but at the price of making the overall system even more disorganized. A staged sequence of limited reform is urgently needed to deal now with the most critical problems and to set the stage for further desirable reforms.

Some general conclusions

Reflecting the conclusions reached in the previous three sections, several principles will be stated as the basis for defining an approach to property tax reform:

¶ Property tax reform must reflect the fact that the municipal tax system should be structured implicitly if not explicitly to include user charges and externality-compensating taxes.

¶ Reform should further reflect the fact that property taxes (particularly taxes on commercial and industrial property) are not capable of being closely related to ability to pay.

¶ Reform must recognize that 'equity' is at best achievable only in very crude terms, and that undue capital losses resulting from the capitalization of unanticipated tax changes should be reduced by implementing transitional provisions.

¶ Potentially significant economic side-effects of tax reform should be offset by incorporating investment incentives into reform proposals.

¶ Any new tax should be implemented in as clear and comprehensible a form as possible. Legislation and/or regulations should clearly define the relationships between appraised values, taxable assessments, and taxes.

85 As noted earlier, the easiest transitional provision is simply a phase-in period.

¶ Equity and land use planning considerations imply that different types of properties should be taxed to differing degrees.

¶ Municipal tax reform need not imply that all uses of property be taxed only through use of the property tax. Reform may be easier if taxes on commercial and industrial land uses are levied through a tax that is more clearly differentiated from the property tax applied to residential property.

The first priority in property tax reform is to respond to the problems reflected in the present flood of assessment appeals. The effects of the appeals are intolerable not only because of their administrative costs but also because of the arbitrary and necessarily inequitable tax shifts caused by the appeals. The present implementation of the property tax is arbitrary and chaotic, and rationalizing the property tax must be a first priority. How to do so is outlined below.

There are numerous reform alternatives that would as a by-product rationalize the current property tax system. 'Rationalization' should consequently be viewed as a minimal goal of property tax reform, to be achieved either as part of a larger reform program or independently. If viewed as part of a larger program, its implementation should be given priority. A logical staging of a more thorough reform program is to divide it into two phases: the first being to rationalize the administration of the present system, the second to implement reforms that go further. The most desirable further reforms are described later.

Rationalizing the current system

To rationalize the present system, several points are worth emphasizing:

¶ The 'administrative market value assessment' approach described in Section 4 provides a starting point, as does the present provincial encouragement of municipally initiated reassessment with classes under the authority of Section 86 of the Assessment Act.

¶ The principal defect of the present use of Section 86 reassessment to rationalize the system is that classes have generally been too large. Residential properties should be classified by age, type, location (e.g. by ward within a city), whether owner-occupied, and by zoning designation. With respect to commercial properties, there should be greater differentiation among uses. Small retail stores should be differentiated from regional

shopping centres; retail uses should be differentiated from office uses. In addition, age, location, and zoning designation should be considered as classifying variables for commercial property. At a minimum, property in the central business district of large cities should be differentiated from property in less congested locations.

¶ Even though a 'mere' rationalization of the existing system does not imply shifts of taxes from one class to another, significant shifts may (and in most larger municipalities will) occur within each class. Transitional phase-in mechanisms should be included to moderate the impact of such shifts.

¶ Making property taxes proportional to market value within classes may have a negative impact on investments that maintain neighourhood quality. Investment incentives to offset this effect should be included as part of a tax reform package.

¶ In rationalizing the current tax, an attempt should be made to increase its comprehensibility. To this end, legislation should specify that assessment notices include the appraised value of a property, its classification, the ratio of taxable assessment to appraised value in that class, and the taxable assessment for the property.[86] Where improvements have been made that are exempted from tax, the notice should state the appraised value inclusive and exclusive of the exempted improvement. More detailed information should be provided for mixed-use development.[87]

Whether as part of a more comprehensive set of reforms or adopted by itself, a classified property tax system reflecting those criteria would improve both the equity and the administrative efficiency of the Ontario property tax. The case for administrative market value assessment is compelling (provided classes are numerous), and undesirable side-effects would be substantially mitigated by the transitional provisions and invest-

86 It is assumed that the ratio of taxable assessment to appraised market value is the same for all properties in a class. Alternatively, this ratio might be varied within a larger class in accordance with a specified formula relating it to property characteristics. If so, the formula together with the observed characteristics for a property should be provided as information with the assessment notice.

87 For properties containing more than one type of use, this information should be provided for each use. In addition, where appraised market value is calculated for the property as a unit and then allocated among uses, the assessment notice should include a record of the data (e.g. floor areas) used to allocate total market value.

ment incentives proposed above. Administrative market value assessment should be adopted for all municipalities in the province without waiting for municipal invitation.

As these points indicate, the basic emphasis in rationalizing the present system should be on eliminating the most obviously identifiable inequities (namely, differences in effective tax rates for closely comparable properties). A secondary emphasis is on clearly defining the role and function of assessment courts, which in these proposals would be limited to determing whether an appraised value correctly reflects the actual market value of a property.[88]

There are a number of defects in the reassessments which have been made under Section 86. First, as noted above, classes have been too large. It is a curiosity that assessment/appraised value ratios differ significantly between lower-tier municipalities within the Regional Municipality of Waterloo after Section 86 reassessment but there has been no geographic subdivision of properties within municipalities. Second, except in the case of Hamilton, no transitional provisions have been implemented.[89] Third, comprehensibility could be enhanced by clearly differentiating between taxable assessment and appraised value on assessment notices.

To clarify the basis for appeals, legislation should provide that the Assessment Review Court may vary appraised market value for a property only where such appraisal can be shown to differ from the 'true' market value of the property on the date of valuation. Legislation should also specify the procedure for establishing valuation dates and for subsequent revisions of ratios of taxable assessments to appraised market values; in particular, it should provide that any reassessment resulting from the use of appraised values for a new benchmark date should be accompanied by

88 As noted previously, 'actual market value' needs to be clearly defined as the value of a property in its present state if sold in an arm's-length transaction in a market corresponding to market conditions in a benchmark period. To reduce the assessment biases it should be stated that (except where otherwise provided for land use planning reasons) appraisals should be based on the higher of value in present use and value if redeveloped to the 'highest and best' uses permitted by existing land use regulations.

89 In Hamilton a phase-in was adopted by the Municipal Council in the form permitted by Section 505 of the Municipal Act. It would be preferable for the phase-in to be specified in terms of taxable assessment and clearly reported on assessment notices mailed to property owners.

such changes in taxable assessment/appraised value ratios as are required to leave aggregate tax revenues from each class of property unchanged at current mill rates. Such a provision is needed to ensure that undesired redistributions of tax burdens (as occurred in California in 1976-78) do not occur in future reassesments. Where such redistribution is desirable, it should be accomplished through passage of a municipal by-law changing ratios of taxable assessment to appraised value, subject to provincial approval and the procedural protections proposed in Section 6.

In implementing any form of market value assessment, transitional provisions should be included that reflect the costs and transitional inequities resulting from tax changes. A phase-in, perhaps the easiest form of transitional provision to implement, should be of significant length, say ten years. In addition, supplementary provisions should be included to ameliorate the potentially destabilizing effects of redistributions of taxes within classes that occur as a result of subsequent reassessments. (The proposals in the preceding paragraph only prevent redistributions from one class to another.) A satisfactory means of doing so would be to provide for an interest-free deferral of taxes arising from increases in assessments that are greater than what would have occurred if assessments had increased at the lower of the rate of general price inflation and the average rate of increase of property values in the municipality. Because the purpose of this tax deferral is primarily to deal with problems created by tax increases for property owners subject to capital rationing, it should be implemented only for homeowners and for small retail businesses owning the premises they occupy. Deferred taxes should be subject to recapture when the property is sold or no longer occupied by the owner.

To offset economic side-effects that might harm residential neighbourhoods, taxable assessment should be based on the appraised value of the property exclusive of value created by improvements made by the current owner that do not change the number of dwelling units or increase usable floor space by more than 10 per cent. This would be achieved by requiring that increases in appraised value attributable to such improvement be excluded in calculating taxable assessment. A similar exclusion could apply to improvements to small retail stores that do not significantly increase the usable retail space such stores; this qualification can be implemented by providing that the amount of usable retail space after any improvements excluded from taxable assessment may not exceed a stated multiple (e.g. 110 per cent) of the area of the store when acquired by the present owner.

In both cases the exclusion should cease when the property is sold or the ownership otherwise transferred.

Beyond the defects of the technique used in Section 86 reassessment, it would be desirable to rationalize the property tax province-wide rather than relying on municipal initiatives. The recent use of Section 86 has been useful as a trial run, but it is clearly undesirable to have a multitude of assessment systems within the province. Reassessment procedures when refined and extended should be implemented for all municipalities in the province.

Further reform priorities

To go beyond mere rationalization to improve the equity of the property tax system is difficult, not merely because of the inevitable political opposition to change but also (and more fundamentally) because it is difficult to specify an 'equitable' property tax. The classified property tax system in current operation may not be equitable, but it is not easy to propose changes that unambiguously improve it. The property tax is inherently a 'second best' form of general taxation.

It is curious that the only reform which would clearly increase the equity of the property tax has received little attention. As we have seen, the taxation of non-residential property to pay for education and social services is at best randomly related to taxpayers' ability to pay, and it would be highly desirable to eliminate this portion of the property tax on non-residential properties. The present overtaxation of such property is the clearest source of inequity between classes in the property tax. Taxes on non-residential property should be reduced; at a minimum, such property should be exempt from taxes imposed to pay for education costs.[90]

For the most part, further improvements in the equity of the property tax will occur in two ways: making variations in effective tax rates a better reflection of the different costs of providing municipal services to properties of varying uses, characteristics, and location; and reducing the

90 To finance this without raising taxes on residential property, a substantial increase in provincial grants to municipalities would be required. It would accordingly be necessary to impose an increase in existing provincial sales and income taxes or to establish a new tax on business output to pay for the reduction in property taxes. The important point is that such a tax substitution would increase the overall equity of taxation in the province.

extent to which the property tax is used as a source of general revenue. The first requires better measurement both of variations in servicing costs and of social costs resulting from global externalities of property development. The second can be achieved by a more extensive integration of the property tax with the income tax, as well as by an expansion of provincial grants to municipalities.

To facilitate such improvement, it would be useful to divide the property tax into two separately identified components: a 'property services tax' and a 'municipal general revenue tax.' Revenues from the first component would be allocated to municipal expenditures on protective and property services (fire, police, garbage pickup, sewage, etc.) and on local roads and parks. Revenues from the second component would be allocated to general administrative expenses, education, and municipal services of a non-local nature. Variations in assessment/appraised value ratios to reflect the different costs of providing services to different property classes would then be implemented only for the first component.

Improvements in the first component of the property tax would be facilitated by greater use of separate municipal taxes either to pay for specific services (e.g. user charges for garbage, servicing, etc.) or to compensate for externalities from particular land uses and and/or development patterns. The use of municipal parking taxes to discourage automobile use by commuters to city centres served by transit (and incidentally to cross-subsidize transit use) is an obvious revenue source underutilized by municipalities; local improvement levies are another.

An additional advantage of dividing the property tax into the two components defined above is that the distinction between the components of municipal taxes which should clearly be levied on a 'benefits' basis and taxes which should be levied on the basis of ability to pay is emphasized thereby. This not only may enhance citizen understanding of the property tax but may also facilitate other improvements.

A provincial income tax credit to ameliorate the undesirable redistributive effects of the property tax should be restricted to the second component. Identification of the two components would permit the provincial tax credit to reflect variations across municipalities in the relative importance of the second component.[91]

91 An ability to do so will become of increasing importance as the aging of municipal populations leads to greater variations between municipalities in the relative magnitude of education costs.

9 COROLLARY REFORMS OF PROVINCIAL GRANTS TO MUNICIPALITIES

The proposals made in the previous section would result in a property tax not based uniformly on market value. They follow from the conclusions in earlier sections that making property taxes uniformly proportional to market values would be inequitable and would have potentially harmful economic effects.

Some equalization of municipal tax burdens across the province is now done by provincial grants to municipalities. How should such grants be defined? Property tax reform is an integral part of a more general reform of municipal finance, including the provincial grant structure. To what extent, therefore, are property tax reform and grants reform interrelated? We look first at the purposes of equalization grants, then at how municipal ability to pay should be defined, and finally at a new formula for calculating the base of such grants.

I argue that it is neither necessary nor advisable for equalization grants to be based on municipal assessment. Instead they should be based on a measure of the total ability to pay of municipal taxpayers. This proposition allows equalization grants to be more equitable. It also clearly separates the definition of equalization grants from the issue of property tax reform. This is of particular importance because consideration of property tax reform has often been constrained by a presumption that equalization grants must be calculated from the municipal tax base.

Objectives of equalization grants

The problem with which equalization grants deal is that of unequal fiscal capacity. Some municipalities have a relatively strong fiscal base. Their tax revenues are sufficient to meet normal municipal expenditure requirements even though their average tax rates are lower than those of less fortunate municipalities. Equalization grants provide supplementary funds to municipalities with a relatively low ability to pay for municipal expenditures. They are generally of importance only for categories of expenditures that do not provide benefits directly allocable to property and so should be financed by taxes based on ability to pay.[92]

92 Exceptions to this statement may arise in cases where there are signi-

The policy that the provincial government should provide grants to municipalities that have difficulty financing 'normal' municipal expenditure requirements is generally assumed to be based on an objective of redistributing resources to municipalities that are in some sense 'poor.' How should such poverty be defined? Generally, a 'poor' municipality has been one with a low tax base in relation to required expenditures. A different definition of municipal 'poverty' will now be proposed, one more closely related to the concepts of interpersonal equity discussed in Section 2.

A government (whether municipal or otherwise) may be viewed in two different ways: either as simply an agent for the provision of public goods which can be efficiently supplied only through some collective agency or as an institution with another purpose as well. If a municipal government is seen primarily as an agent, its role is like that of a consumers' co-operative, and its 'ability to pay' for collective consumption goods is appropriately measured by aggregating municipal residents' ability to pay for consumption goods. This model is obviously complicated if municipalities are permitted to levy taxes on non-residents in order to provide public services to residents (as is the case with property taxes levied on firms to pay for education expenses), but the resulting complications are no greater than in the case of a private consumers' co-operative endowed with an additional income source. In both cases, the aggregate ability to pay of municipal residents (or members of the co-op) is their collective ability to consume, which is obviously increased by the additional income.

Though high-level governments now have an independent function that makes them more than 'mere' agents for residents (thus for example requiring a more complex model of the 'ability to pay' of provincial governments in analysing federal-provincial equalization grants), there is little in the expenditure function of municipalities that goes beyond a pure agency function in any significant way. I will consequently argue that, consistent with this agency function, a municipality's ability to pay should be defined as the aggregated ability to pay of its residents.

The purpose of equalization grants should therefore be formulated as one of obtaining resources through general (provincial) taxes and redis-

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ficant economies of scale in the provision of local services to property and where a municipality is either too small or density of development is too sparse to permit such economies to be realized.

tributing them through provincial-municipal grants to residents of municipalities that (as a collective) are relatively less able to pay for some standard level of public services. Such a formulation requires both defining what is meant by 'normal' municipal expenditure requirements and establishing the municipality's aggregate ability to pay for such expenditures. The first defines need; the second defines what resources are available to taxpayers to meet this need.

Defining a standard level of municipal expenditures is not easy, because the costs of providing 'normal' services to the inhabitants of a municipality can vary widely. For this reason, it is convenient to define different cost formulas for different expenditure categories, so that there would be separate estimates of 'need' for regional highways, education, social services, and other categories. It is then necessary to devise some 'standard cost' function to relate normal expenditure requirements in each category to observable characteristics of a municipality.

In education, it is fairly easy to define a standard level of expenditure requirements, since education standards are largely set by the Province and their cost may to a considerable extent be assumed to be a relatively uniform function of student enrolment in each level of education.[93] Where there are no provincial standards but where relatively uniform types of demand for services can be presumed, an empirically based estimated cost function may be specified that takes variables into account (such as age composition or population density) that may cause variations in costs per household.

Measuring 'standard' costs of a 'normal' level of services is an important aspect of implementing any equalization grant. In this section I shall assume that aggregate costs have somehow been specified and focus on how a municipality's aggregate ability to pay should be defined. Since the objective of equalization grants is to offset variations among municipalities in the relationship between costs of general services and taxpaying

These exceptions will be ignored here, so that attention may be focused on equalization grants for general services not allocable to property, such as education.

93 Such a function need not make costs for each schooling level proportional to student enrolment; economies of scale, effects of student dispersion (including costs of school bus transportation), and other special factors (such as number of children in minority groups requiring special education) may easily be reflected in a standard cost function.

capacity, total ability to pay must be measured by aggregating the ability to pay of all taxpayers within the municipality.

The variations in the ability of municipal taxpayers to pay for general services of a particular type may be measured by computing a 'fiscal capacity index' (FCI) for each municipality, defined as the aggregate taxpaying capacity divided by the aggregate costs of 'normal' services. This index can then be used to decide whether a municipality is eligible for a grant and, if so, its size. Each of these definitions may vary, depending on the desired degree of equalization. In general, the eligibility condition would be implemented by making a municipality eligible for an equalization grant if its FCI were below some standard. (This standard might be the weighted average FCI for all municipalities in the province, or it might be some higher level.) Grants received by eligible municipalities could be specified as the total amount required to reduce their aggregate expenditures subject to equalization to a level at which their FCI equalled the specified standard, or as some fraction of that amount.

The purpose of equalization grants is to offset the effects of intermunicipal differences in taxpayers' ability to pay for a 'normal' level of services. Much confusion about that impedes discussions of equalization grants. I assume that municipalities have no significant function except as an agent for a group of individual households. Municipalities themselves consequently have neither 'ability to pay' nor a demand for services; only their inhabitants have such abilities and demands.

It has been traditional to base equalization grants on municipal assessment.[94] This is consistent with the foregoing model of grants only if total property assessments are a good proxy for aggregate taxpaying capacity. Unfortunately, this assumption is unlikely to be correct, for reasons that have been discussed at length in Section 2.

Defining aggregate taxpaying capacity

Because a municipality's ability to pay for municipal services is based on the aggregate taxpaying capacity of its inhabitants, any fiscal capacity

94 There are nevertheless some examples of equalization grants in which aggregate incomes are used as one factor in defining municipal 'ability to pay.' This is done in computing U.S. federal grants to municipalities; another example is the new Australian program of grants to municipalities through the Australian Grants Commission.

index should be derived from a specification of ability to pay for individuals and firms within the municipality. That principle may be applied in a variety of ways, depending in part on the availability of data. Nevertheless, since the purpose of the fiscal capacity index is to relate 'normal' expenditure requirements to aggregate taxpaying ability, empirical estimates of the numerator of the fiscal capacity index should (as much as possible) relate directly to a proper definition of ability to pay. Where (as with the property tax) a tax base is not a very good proxy for taxpaying ability, a direct estimate of ability to pay is clearly preferable.

As noted in Section 2, ability to pay is most directly related to ability to consume. In the case of individuals, this ability may be measured by reference to data on incomes. Alternatively, lifetime consumption plus bequests can serve as a basis for defining ability to pay.

At a practical level, the choice of an index of ability to pay must depend in part on data availability. It is not practical to use a consumption-plus-bequest basis for measuring aggregate ability to pay in a municipality because of measurement difficulties. Aggregate incomes of municipal residents may by contrast be measured quite easily. Data on aggregate assessable incomes by municipality as reported on individuals' personal income tax returns are available annually from computer-compiled tax-return data provided by Revenue Canada to the provincial Ministry of Revenue.[95] Corresponding data on total provincial and federal income taxes paid should be used to construct an estimate of the total after-tax income of municipal residents, since taxpaying capacity at the municipal level is clearly reduced by taxes paid to higher levels of government and so should be based on aggregate disposable personal income.

The available data on aggregate assessable income by municipality is deficient in a number of respects. Assessable income does not include accrued unrealized capital gains, and it further reflects a number of tax preferences which cause income assessable for tax purposes to differ from

95 For counties and larger cities in Ontario, more detailed data on income components are already published in Revenue Canada, Taxation Statistics, annual issues. To obtain aggregate assessable income by municipality, data on individual taxpayers must be tabulated by computer processing of the Revenue Canada taxpayer master file. A copy of this file, containing summary income data and municipal address for every taxpayer in Ontario, is furnished to the provincial Ministry of Revenue under the terms of the federal-provincial tax-sharing agreement and so can be processed by provincial officials.

actual income. Unreported income (particularly among self-employed individuals) may be significant. Further, a number of taxpayers use business offices as their addresses on tax returns, so that their income may be allocated to a municipality other than the one in which they reside.[96] Whether these deficiencies significantly affect the accuracy with which aggregate assessable incomes measure the taxpaying capacity of municipal residents depends on two things: how important they are in the aggregate and how much the resultant errors vary compared to the aggregate reported income across municipalities. Even with these deficiencies, tax return data on incomes provide a better measure of municipal taxpaying capacity than other available data.

As already noted, net municipal revenues from property of non-residents should be treated as the equivalent of additional income of residents; businesses should otherwise be ignored in defining aggregate ability to pay of residents. In any case, for firms it is not feasible to obtain data on net incomes of establishments within municipal boundaries.[97] Firms, institutions, and other taxpayers apart from individuals will consequently be ignored in defining the aggregate taxpaying capacity of a municipality. However, since any excess of property tax revenues from non-residential property over the costs of municipal services allocable to such property should be treated as equivalent to income of residents, such excess will be deducted from the costs of 'normal' expenditures.[98]

96 This deficiency might be rectified by requiring taxpayers to include on their tax return the municipality in which they resided as of 31 December of the year for which the tax return is filed.

97 This problem arises for two reasons: (1) Tax returns filed by multi-establishment corporations using facilities in different municipalities do not give information on an establishment basis, so that corporate income as reported in tax returns cannot be allocated to municipalities of origin. (2) Even if they did, it would be difficult to regulate or even evaluate internal transfer prices used to allocate general and administrative expenses to establishments.

98 The deduction of such excess from 'normal' expenditures is in effect imposing an implicit provincial tax on the difference between municipal revenues from non-residential property and the costs of servicing such property. The implicit tax rate is defined by the equalization grant formula; in the representative scheme outlined in the next section, this tax rate is equal to the parameter GF. Reflecting net municipal revenues from non-residential property in this way is a second-best substitute for eliminating property taxes on non-residential

There is little equity justification for using the property tax as a means of collecting general revenues (i.e. revenues to finance services that do not provide direct benefits to properties) from commercial and industrial properties. The incidence of property taxes on commercial and industrial property is very poorly related to ability to pay, and it would be desirable on equity grounds to reduce such taxes. In equalization formulas they should be taken into account only as a revenue source that reduces the fraction of aggregate costs of 'normal' services that must (in the absence of grants) be paid for by taxes on residential property.

Equalization formulas

The calculation of equalization grants is necessarily complicated, and will be illustrated by developing an equalization formula that reflects the points just noted. In principle, however, any equalization formula has a relatively simple structure. The complexity results from the allocations necessary to implement that underlying structure.

The elements of an equalization formula are, first, an eligibility rule and, second, a formula for calculating grants to eligible municipalities. It will again be assumed that the grants are structured to bring municipal revenues up to some specified level and that there are no 'negative grants.' This reflects an assumption that it is more equitable to finance equalization grants to poorer municipalities from general provincial tax revenues than from increased property taxes in wealthier municipalities.[99] As with any other redistributive transfer program, the costs of equalization grants are more equitably met through a uniform provincial income tax (or

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property as a source of revenue to pay for general expenditures.

99 This is in contrast to the present system of equalization grants for education, in which aggregate provincial grants are defined to be equal to a specified fraction (at present 51 per cent) of total municipal expenditures on education, but grants to specific municipalities are varied from this average in order to reflect positive or negative equalization factors. For Metropolitan Toronto, for example, the resultant provincial education grant is now only 20 per cent of education expenses, reflecting a substantial 'negative equalization' grant. The cost of the resulting transfer from Toronto residents to the rest of the province is borne by low-income residents through higher rents and lower wages, as well as by other residents through the direct incidence of the property tax.

sales tax) that is at least mildly progressive than by increased property taxes whose incidence is more random.[100] Since the property tax is a poor technique for levying taxes based on ability to pay, it should be used as a municipal levy to pay for general expenses only if municipally varying consumption or income taxes are not feasible. There is clearly no need to use them to pay for the costs of a provincial transfer program.

As noted earlier, an eligibility rule can be stated using a 'fiscal capacity index' that defines aggregate taxpaying capacity per dollar of expenditure required to maintain a given category of municipal general expenditure at some 'normal' level. Such an index must treat non-residential property differently from residential property. Ideally, this would be accomplished by eliminating property taxes on non-residential property beyond those required to pay for property-benefiting services or to compensate for negative global externalities. In that case the cost of aggregate municipal expenditures on 'general' services such as education would (in the absence of grants) be exclusively borne by taxes on residential property, and taxpaying capacity would be simply the aggregate ability to pay of municipal residents. In the absence of this ideal, the share of costs of 'general' services borne by non-residential property should be deducted from such costs, so that the service costs being equalized would be those borne by taxes on residential property.

Implementing this principle means that three items of information are required for each municipality: (1) the aggregate cost for the municipality of providing this 'normal' level of services in each category of expenditures subject to equalization, (2) the fraction of these costs which would be borne by taxes on non-residential property in the absence of any grants, and (3) the aggregate taxpaying capacity of households resident in the municipality. Defining the latter as aggregate disposable personal incomes, calculated from data reported on personal income tax returns filed by individuals resident in the municipality, a fiscal capacity index (FCI) for

100 This is particularly true of the portion of the surcharge on property taxes that is levied on commercial and industrial property. The long-term incidence of the tax on industrial property is likely to be largely in the form of lower wages to industrial employees, and so is very possibly regressive. As a by-product the tax encourages relocation of industry away from 'wealthy' municipalities in which it is economically most efficient for them to locate.

each municipality would then be defined as

$$FCI = \frac{API - PIT}{ACNS\ (1\text{-}FNR)},$$

where API is the aggregate before-tax personal incomes of individuals residents in the municipality, as reported on tax returns; PIT is the aggregate personal income tax paid by residents of the municipality; ACNS is the aggregate cost of providing a 'normal' level of services in all expenditure categories subject to equalization, computed in accordance with 'standard cost' formulas for each category; and FNR is the fraction of total municipal general service costs allocable to non-residential property.

In this formula all variables other than FNR are well defined. If the property tax is split into two parts with a separately determined 'property services tax' or family of user charges, then FNR is simply the ratio of total non-residential taxable assessment (including 'business tax' surcharges) to total taxable assessment on all properties.[101] If the property tax is not split up in this way, then the definition of FNR should (ideally) be adjusted to reflect differences in the relative importance of implicit user charges as a component of taxes on each type of property.

After a fiscal capacity index for expenditures subject to equalization had been computed, a municipality's eligibility for equalization grants would be defined by comparing its FCI in that category to some provincially specified critical value. If its FCI was less than this critical value, the municipality would be eligible for a grant. Ideally, this eligibility limit would be specified in legislation as some ratio (e.g. 120 per cent) of the weighted average FCI for all municipalities in the province, so that the equalization formula would be stable in relative terms across years and not need to be changed each year.[102] The value of this ratio is one of two parameters defining the extent of equalization.

101 More particularly, if the present system of business taxes is continued, the numerator of FNR should be aggregate taxable assessment on non-residential properties for property tax purposes plus additional assessment for business tax. The denominator of FNR should be this total plus aggregate taxable assessment on residential properties.

102 The weighted average FCI for all municipalities is easily calculated by separately aggregating the numerator and denominator of each municipality's FCI and then dividing the total of the numerators by the sum of the denominators.

For municipalities that are eligible for an equalization grant, the amount of the grant would be defined as some fraction of the difference between the aggregate standard cost allocable to residential property in the municipality and what this amount would be if the municipality's FCI were equal to the eligibility limit. This latter amount will be denoted as an 'expenditure standard,' defined as

$$STD = \frac{API - PIT}{EL},$$

where API is aggregate personal incomes before tax reported by individuals resident in the municipality; PIT is the total personal income tax paid by these individuals; and EL is the provincially defined eligibility limit for equalization grants (the critical value of the municipal fiscal capacity index). Accordingly, the equalization grant (G) for which the municipality would be eligible would be

$$G = [ACNS(1 - FNR) - STD]GF,$$

where ACNS is the aggregate cost of 'normal' service levels in all categories of expenditures subject to equalization; FNR is the fraction allocable to non-residential property; STD is the expenditure standard, defined above; and GF is the fraction of the difference received as a grant. The provincially defined parameter GF is the second of the two parameters defining the degree of equalization.

Suppose GF is defined as unity and EL is defined as the (weighted) average of municipal fiscal capacity indexes for all municipalities in the province. Then only those municipalities whose fiscal capacity index is below this provincial average would be eligible for equalization grants; the amount of the grants to eligible municipalities would be sufficient to bring the cost of a 'normal' level of municipal services down to what it would be if the municipality's fiscal position were the same as the provincial average. This reflects the assumed purpose of the equalization grant: to assist individuals who collectively have below-average per capita resources to pay for a 'normal' level of municipal services that are not of direct benefit to property.

Equalization grants calculated in accordance with the foregoing formula would compensate for the relative lack of taxpaying capacity in municipalities with below-standard ratios of aggregate after-tax incomes to total

net standard eligible expenditures. Of course it is also possible to define a different equalization grant, one that equalizes down as well as up; all municipalities would then be 'eligible' for grants, but the amounts might be negative. The formula defining 'negative grants' would be the same as that defining positive grants; negative grants would occur for municipalities whose fiscal capacity index is above the eligibility limit. Negative grants would normally be defined as deductible from provincial grants otherwise payable.

Negative grants are undesirable. I mention them simply to show that the equalization formula described in this section may be used to obtain any desired type and extent of equalization.

10 CONCLUSIONS

There are three essential conclusions to this paper. First, the basis for previous recommendations for making municipal property taxes uniformly proportional to market values is surprisingly weak. This is not to say that the municipal property tax is not in need of reform, but rather that the type of reform needed is both less drastic and more sophisticated than has previously been proposed. Second, there are a number of valid reasons why it might be appropriate to continue many of the existing variations in ratios of assessment to market value. These reasons include differences in relationships between market values and taxpayers' ability to pay, user charges that should be included in municipal taxes and are in part reflected in existing deviations of assessments from market values, and negative economic effects that might be induced by some of the tax changes. Third, the key reform priority should be administrative reform; a secondary priority should be the reduction of property taxes on industrial and local retail property. The equity rationale for further reform on a uniform province-wide basis beyond these two priority items is weak.

To reflect these considerations, a number of proposals have been made. They would result in fewer (and, on average, smaller) tax changes than the adoption of a property tax made proportional to market value. The proposals incorporate transitional provisions that would ameliorate the arbitrary redistributions of wealth inherent in reform without permanently preserving existing anomalies that should be eliminated.

Much more attention be given to utilizing additional tax instruments to

incorporate user charges into the municipal tax structure. There is substantial potential for utilizing the existing property tax system in this way. This may be done by making assessment dependent on variables related to service benefits and/or social costs as well as on market value. Alternatively, it might be done by defining additional, separately identifiable taxes such as municipal servicing and parking taxes. (The servicing taxes would be collected through the existing property tax system and so in effect would be an attempt to identify separable components of a property tax.)

The reform of municipal equalization grants inevitably must accompany the reform of municipal taxation. The proposals above would make such grants more reflective of differences between municipalities in the average taxpaying capacity of municipal taxpayers. Such changes would also be consistent with the equity arguments underlying the proposals on taxation.

Property Tax Reform in Ontario: An Economic Assessment

Michael Denny

INTRODUCTION

For a few months in 1978 property tax reform in Ontario seemed imminent. Then it was halted. After a decade of debate, committees, and investigations, the Ontario government was unable to find a tax reform program that seemed viable. But if major initiatives to reform the property tax have been stopped, many smaller changes are occurring, and the introduction of market value assessment may be expected in the next few years. The latter does not itself necessitate large changes in the existing pattern of average tax liabilities, but the design of the mill rate system to accompany market value assessment does, and that is what has resulted in public displeasure and political discomfort.

Market value assessment is a desirable reform, and no criticism of it in principle is contained in this study. But the estimation of the market value of many properties creates serious difficulties, and these are discussed. In particular, it is important to lift the secrecy that has surrounded assessment in the past.

In January 1978 the Treasurer of Ontario, Darcy McKeough, attempted to design a new mill rate structure to accompany market value assessment called the 'Alternative System.' Though ultimately rejected, it was an example of the type of reform that is still relevant. In particular, it showed clearly the political issues at stake.

The basic question is very simply. Do we want an Ontario property tax that takes an equal proportion of the value of each property within a given municipality? This radical change from current practice would require important short-run shifts in tax liabilities. If we do not want this sort of tax, what do we want? And who should decide - the Province or each municipality?

This is not a historical or a political study but an economic analysis

I would like to acknowledge substantial assistance from John Bossons of the University of Toronto and Enid Slack of the Ontario Economic Council. Further debts are owed to R. Bird and M. Bucovetsky of the University of Toronto. The participants in the Ontario Economic Council seminar were very helpful, particularly several members of the Ontario civil service. The results are mine.

of the consequences of altering the assessment base and moving towards a common tax rate structure defined by the Province. Our example is the Alternative System.

The general issues surrounding the reform are discussed first. Equity has been an underlying theme. The practical concept of equity underlying the Alternative System is approximate, but sophisticated notions of equity are difficult to apply to this tax in isolation from other taxes and from grants. Efficiency questions, particularly the long-run effects of the reform, have not received enough attention, and a brief survey of these problems is included. The most pertinent political question is the role of the local governments in a new property tax system. Should they be given the power to allocate locally the burden of tax liabilities among property classes?

Many Ontario municipalities have been using a market value tax system for a number of years, and in the second section of the paper the experience of the city of Mississauga is used as an example. The third section discusses the difficulties of estimating the market value of different properties and indicates possible ways to improve estimates through time. The final section reviews the impact problems of the Alternative System to suggest the difficulties facing further reform.

GENERAL PROBLEMS OF PROPERTY TAX

General considerations

Though the question of a market value property tax system has been discussed in Ontario for a long time, only in the last decade were serious efforts made to implement one. The reasons behind the proposal were not abstract and intellectual but practical: the results of the existing property tax system were judged to be unsatisfactory. In particular, the increasing role of the provincial government in funding municipal governments during the 1960s was crucial. Some attributes of the old system help explain the motive force for reform.

Certain terms are useful to know. All properties have an assessed value, which may be zero. The tax liability of a property is the product of the assessed value and the mill rate. The latter is conventionally defined as the dollar quantity of taxes per thousand dollars of assessed

value. Since the tax revenue from any property is the product of two numbers, an infinite number of combinations of assessed values and mill rates will generate the same tax revenue. This apparently trivial fact is often neglected in discussions that focus on one of the two components. Properties have a current sales price, called the market value. The effective property tax rate (ETR) is defined as the tax liability as a percentage of the market value.

Dissatisfaction with the existing system centred on the assessments performed in each municipality. The Assessment Act provided rules for doing local assessment, but these were not sufficient to stop mounting criticism of the system. The fundamental flaw was believed to be the inconsistency of local assessment. Consistency within and across municipalities became the main issue. Realistic reform proposals would have to say what type of consistency is desired and show how to achieve it.

The reform was said to be an attempt to eliminate inequities. Thus inconsistencies were seen as inequities. Though not a sham, this view has complicated the reform discussion and the politics of implementation. Consistency is not necessarily equitable. Finding an equitable property tax system depends on having some practical notion of equity, a difficult question that entails value judgements.

McKeough (1978) listed six areas in which the reform was designed to reduce inequities: (i) tax distribution between income classes, (ii) tax distribution within income classes, (iii) distribution of provincial grants, (iv) distribution of costs among the lowest tier of municipalities, (v) government property, and (vi) exemptions of certain properties.

The inequities in tax distribution at which reform was directed were those within a municipality. The effective tax rates varied widely in most municipalities. Table 1 shows the average effective tax rate and its range in five areas of Metro Toronto during 1961 and 1971 for single-family homes. Market value assessment would reduce the dispersion of the effective tax rates for properties in the same class. Non-residential properties and multiple dwellings have often had effective tax rates almost double those in Table 1. A market value assessment combined with a uniform mill rate would eliminate variations in the effective tax rate. In January 1978 Mr McKeough had in effect proposed differential mill rates at full market value. The explicit proposals stated that certain classes of properties would be taxed on only a fraction of their full market value

assessment. For example, single-family homes would have a taxable assessment equal to one-half of the market value assessment. This is equivalent to a mill rate for single-family properties that is one-half of the mill rate for commercial and industrial properties. Equity usually means equal taxes for equal market values within a given property class. Differences across classes are a regrettable political necessity. Although arguments can be made for differential effective tax rates across classes on 'benefit' grounds, they have not received much support in the official studies of the reform. In the short run at least, these differentials could not be eliminated without substantial increases in residential property taxes. The required increases are believed to be politically unfeasible and perhaps even undesirable in the short run. The two sets of proposals for property tax reform introduced in 1978 were unable to overcome political uncertainties and introduce the sharp changes in relative tax liabilities needed to equalize the effective property tax rate across classes.

The distribution of provincial grants and the distribution of costs among lower-tier municipalities, items (iii) and (iv), are partially or wholly based on the assessment of a particular municipality. At present a complex equalization system attempts to place all municipalities on an equal basis proportional to market value. The Province desires that many grants be determined by the taxable market value assessment of the municipality. Similarly, costs are distributed to lower-level municipalities on the same basis. Both grants and upper-level municipality costs are based on the ability of municipalities to tax. This ability is measured by the taxable market value. The Province is proposing that equity in these areas requires a distribution of grants and costs on a basis that includes the market value of property in the municipalities as one dimension.

The remaining items (v) and (vi) have great importance for particular municipalities but require very little analysis here. Government properties are not assessed or taxed at present, though they would be under the Alternative System.

Equity and market value taxation

Equity is not a simply notion.[1] In theory, as in practice, it is strongly

1 The companion paper by John Bossons contains a more detailed analysis of the equity of a market value property tax system.

TABLE 1

Effective property tax rates: Metro Toronto 1961 and 1971

	Area					Total
	1	2	3	4	5	
1961						
Average effective tax rate	1.72	1.56	1.65	1.54	1.77	1.63
(Standard error)	(0.58)	(0.52)	(0.59)	(0.41)	(0.33)	(0.52)
Range	1.14-2.30	1.04-2.08	1.06-2.24	1.13-1.95	1.44-2.10	1.04-2.30
1971						
Average effective tax rate	1.50	1.31	1.30	1.49	1.42	1.39
(Standard error)	(0.44)	(0.62)	(0.43)	(0.56)	(0.37)	(0.53)
Range	1.04-1.94	0.69-1.93	0.87-1.73	0.93-2.05	1.05-1.79	0.69-2.05

NOTE: Data were collected by Dewees (1976) and used in Denny and Grainger (1974). The first four areas are in the city of Toronto and the fifth in East York. All properties are within one mile of the Bloor Street subway line. See Dewees for a more complete description of the areas.

subjective. At one extreme equity may seem a subjective concept that cannot be measured. But practical judgments must be made about fairness, and it is in practical terms that I discuss the equity of the property tax.

The property tax has survived continuous criticism. The details of the debate about its usefulness are far too extensive to consider here.[2] Studies of the Ontario property tax have given several reasons for keeping it: first, that it is the only local tax that is fairly easy to administer; second, that the large quantity of revenue it produced could not be raised by other taxes; and finally, that a number of distributional issues favoured it (Blair 1977, 2-8), such as its treatment of non-residents, the lack of exemptions for any income classes, and the consequences for tax collections of more senior governments. The first two reasons are not convincing. There is no evidence that the administrative costs of the

2 Smith (1967, III, chap. 9) discusses the continued necessity of a property tax.

property tax are lower than those of other taxes (Netzer 1966). Since revenue must come from income earners one could indeed design an income or excise tax to replace the property tax, particularly if the fiscal system were considered as a unit. Designs for the integration of various tax systems have been proposed, for instance by the Carter Commission, though recent experience in Canada suggests that such reforms are not attainable.

The real virtue of the property tax is that is is widely recognized by citizens as a separate tax under the control of local municipalities. The local services it provides are known to residents, though the importance of the Province in financing local services is often underestimated. In addition, the property tax does tax the non-income-earning wealth in the owner-occupied housing stock.

The retention of the property tax means that equity across all taxes is unlikely. That would require integration. One tax among many thus cannot by itself satisfy certain notions of fairness.

Even with the property tax alone some interesting questions arise. What is the purpose of the tax? Is it going to bring its benefits to the taxpayers? If it is not, does equity simply mean an equal tax liability for an equal market value? Municipal governments provide a variety of public services funded by grants, property taxes, and direct service payments. The division of funding depends on the purpose of the expenditure, which in turn complicates the question of fairness.

Strange arguments revolve around the purpose of the property tax. The Blair Commission claimed that the property tax was not a benefit tax, i.e. one whose benefits accrue to those who pay it.[3] For reasons of equity and efficiency this claim requires close scrutiny. One may argue that the property tax should be a tax on a particular form of wealth, real estate. But it is not clear why one form of wealth should be taxed when other forms are not. To do so creates incentives for investment that are not necessarily desirable. The equity issues contained in any particular distribution of real estate wealth are hopelessly outweighed by wider questions of wealth and income. If benefits are to be entirely independent of tax liabilities, then the property tax is not likely to satisfy any soph-

3 The attack on the benefit principle may simply reflect the obvious fact that a large proportion of municipal government expenditure could not be financed on the basis of any benefit principle.

isticated notion of equity. For equity rests entirely on the argument that equal taxes for equal market value are fair. This is rough justice at best.

It has also been argued that the property tax should not be an income tax; that is, ability to pay in terms of either the productivity of the real estate or the money income of the owner ought not to be a criterion in the design of the tax. Logically, a tax on wealth is a tax on income, although obviously not on money income. If market value assessment were combined with a uniform mill rate, the property tax could be described as an imputed income or consumption tax for owner-occupants. That interpretation will not do for other types of properties. For profit-seeking businesses, the tax is part of the cost of using capital in the form of structures and land. Without a complicated analysis of the incidence of the tax it is not possible to provide a common interpretation.[4]

The persistence of tax differentials between similar properties in the reform proposals suggests that equity is a historical concept. Large shifts in property taxes between classes are thought to be inequitable. This belief is undoubtedly due to the unpredictable shifts in tax liabilities and the resulting capital gains and losses that may occur with tax reform.

The importance of the historical pattern of allocating taxes among property classes has arisen because of the sharp changes in relative market prices in the past decade. Prices of vacant land and non-rental residential properties have risen sharply compared to those of other types of property[5]. This may be a temporary rather than a long-run change in relative prices, but it is severely complicating the introduction of the reform. Politicians want to moderate the effects of relative price changes on tax liabilities until they know what those changes will be in the long run.

Although benefits have not been stressed as a basis for property taxation, they deserve more consideration in that regard. Many public submissions to the various tax committees raised this issue. There has

4 Bird and Slack provide an extensive analysis of the old and new views of incidence.

5 Blair, McKeough, and the Provincial-Local Government Committee all attempt to constrain the shifts in tax shares across property classes.

The foregoing discussion defines classifications as fairly broad aggregates of properties, in accordance with the approach adopted in the government's 1978 proposals. As is discussed in the next paper by Bossons, the extent of aggregation is an important determinant of equity; a finer classification of properties is proposed by Bossons.

been an increased interest in non-tax financing of government services during recent years. For local governments, Vickrey (1963) provides an excellent analysis of the possibilities. A more recent and extended discussion is contained in Bird (1976c). It may be claimed that alternative methods of financing municipal services are not part of the property tax. This view is too narrow. Municipal taxation is one means of financing municipal services, and analysing taxes apart from their purpose is of only limited use. The first step of any consideration of a particular tax should be its suitability for financing the relevant public services. The major limitation on the application of the benefit principle to property taxation is the substantial expenditure on education. It is not likely that education will be financed on any narrow benefit concept that places current costs on current users.[6] In other areas, user fees could be expanded, as Vickrey suggests, but difficulties remain. User fees are sensible only when use measurement and fee collection are feasible and reasonably inexpensive, and they are justified only when the user is the sole beneficiary. If wider benefits accrue to non-users, a more complex financing arrangement is required than user fees alone. The various reform committees ought to have considered the possibilities of the benefit principle in more depth.[7]

By accepting market value assessment, the government has endorsed the equity of it. Before the introduction of the reform, however, the real estate dollars held by different groups have not been deemed equivalent. Equity between two groups seems to be measured by market value discounted by the amount by which the groups' taxes differed under the old system.

McKeough's list of inequities reflects only a superficial notion of fairness. At least two broad notions of equity could be publicly acceptable: the ability to pay and some benefit principle. There has been continued reluctance to state any benefit principle. Market value assessment is neither a firm basis for measuring benefits nor a good measure of ability to pay. Bird and Slack (1978) discuss the evidence on taxes in relation to income. The relationship between household income, wealth, rent, and property taxes may have changed in recent years. The growth

6 If the externalities from education are sufficiently large the Province should absorb most of the costs.

7 Blair (1977, 5) has a particularly strong rejection of the benefit principle.

of non-family households and multiple income households and the decline in the number of children have made any simple lifetime pattern of housing and income improbable.[8]

To continue with market value assessment, we need to look at the equity of alternative mill rate systems that permit substantial variation either from the historical pattern or from equal effective tax rates. It will not be possible to define a fair tax when other taxes exist. Since we cannot redesign the entire tax system, we must accept a second-best notion of practical fairness. Perhaps the most difficult question concerns the treatment of residences compared to businesses. But the postponement of reform means we have time to construct a more acceptable form of property tax. Since the basis for equity was not clearly stated in the reform proposals their positive effects have been almost ignored. No significance has been attached to the long-run implications of the reform. Short-run effects have been overemphasized and compromises made for expediency.

Efficiency and market value assessment

Three basic issues in the economic analysis of the property tax deserve more attention: incidence, capitalization, and new housing.

The enormous stress placed on how reform would affect the current taxpayer neglects the question of incidence. A change in the legal liability for tax payments is not necessarily a change in actual costs or expenses. The substantial reduction of tax liabilities on rental buildings with more than five units is an excellent example. Although there has been an immediate windfall gain for apartment owners, their longer-run gain may be much smaller. If tax savings are not passed on to the tenant, short-run profits will rise, and so will the supply of rental units. Property tax payments are roughly 20 per cent of gross rents.[9] If property tax payments were cut by half, this would be equivalent to a 10 per cent rise in gross revenue after property tax. The result would be an incentive to builders to construct new units and consequently a slowing of

8 Shifts in sociodemographic patterns will alter the intertemporal relative prices of different types of properties and the accompanying tax incidence.

9 This will follow if the ratio of taxes to market price is 0.03 and the ratio of gross rents to market price is 0.14.

the increase in rents. Furthermore, owners of existing buildings would be encouraged to improve services to reduce turnover costs. As a result of this increase in supply, rents might even rise much less than they would have without the tax decrease. The benefits of the tax reduction may thus be passed through to tenants in general.[10] The actual division of the tax decrease between tenants and owners cannot be determined by a simple reference to who is legally liable for the payment. The demand for and supply of apartment units and buildings will ultimately determine who benefits from the tax reduction. Any attempt to direct the benefits to tenants in the short run will adversely affect tenants in the long run.[11]

This argument is not restricted to apartment buildings but applies to all properties. A stimulating discussion of the question of incidence is contained in Bird and Slack (1978). The current reform of the property tax provides an excellent opportunity for an intensive study of property tax incidence, and it is very unfortunate that the Ontario government has no plans for one. The evidence from such a study would be useful beyond tax policy as well. We could learn about the demand for and supply of housing. The property tax reform is a large social experiment, and it ought to be analysed as such.

The incidence of property tax changes raises the important question of capitalization. One way in which changes in tax liabilities become distributed is through the capitalization of net income changes that are a direct consequence of the tax changes themselves. For example, large increases in taxes on vacant land will lower its price. The cost of holding vacant land will have increased, and this will be reflected, through capitalization, in the market price of land. Alternatively, elimination of the property tax on farm land will raise the price of it. Similarly, some existing land prices reflect current property tax liabilities. Reform might simply impose a set of capital gains and losses on real properties, so that the chief consequences would be redistributive rather than allocative. The capitalization of tax changes has barely been discussed in the Ontario property tax reform literature,[12] and some of the more spectacular

10 The tenants who receive the benefits will not be exclusively the current tenants, to the extent that turnover occurs.

11 If the current tenants receive the benefits, future tenants will face higher prices.

12 This applies to the published reports of the government and its appointed committees.

allegations of percentage changes in tax rates are overestimates. One cannot estimate the market value of a property independently of the property tax liability. If the property tax liability soars on a piece of vacant land, the market price will fall, and the original tax liability will have to be recalculated.

The incidence and capitalization effects are two of the economic consequences of reform. The long-run impact of the property tax reform has been almost totally neglected. Yet market forces will in the long run decide the issues and provide incentives for development. Land values are determined by the present value of alternative net income streams generated by particular uses. The use of land is determined by land values (and vice versa). Changes in the present value of properties resulting from the tax reform will alter the land use pattern and its rate of change.

Consider a piece of land used as commercial and retail space in the form of an older building in an urban commercial core. Assume that there are long-run prospects for an increase in demand for these uses but that the quality of the space is important. The owner or potential owner must consider alternative uses both today and in the future. A possible sequence of events is the retention of the existing use for a number of years, followed by demolition of the building and use of the land as a parking lot for a number of years, followed by the development of new retail and commercial space. This sequence is common, and its profitability, like that of any particular development sequence, will depend on the tax payments. There are two aspects to the latter, the assessment and the mill rate. The current assessment probably substantially undervalues the property. However, the estimation of the market value of the property may be done by capitalization of rents. This method may result in a market value assessment quite different from the present value of the property including the best possible development sequence.

Since the reform proposals would substantially increase the cost of holding vacant land and parking lots, the decision to do so must be reevaluated. The timing and nature of any new building construction will be altered both by the direct effect of the reform on the taxes paid by the new building and by the revision in the development sequence caused by the changes in taxes on holding land.

Decisions about a particular property must of course be taken within the environment of the market for all properties. Since all these markets

have been altered by the tax reform, no simple and complete analysis of a single property is in fact possible.

The reform proposals would encourage an increase in multiple residences as against single-family residences. Compared to the unreformed property tax system, land-holding and land-using activities would be taxed more heavily. Denser use of land in all activities is encouraged, and open space is penalized.[13] Since urban areas already use zoning and development restrictions to maintain open spaces and limit density increases, the market forces opposing these policies will be intensified. Large lot sizes for residential properties will be penalized because the portion declared excessive will be taxed as vacant land, and all vacant land will pay taxes at a higher rate than developed residential land. New residential and non-residential buildings will be constructed, where allowed, at higher building-to-land ratios. Conversion of existing properties to less land-intensive uses is encouraged, particularly for older properties. In rural areas, enormous incentives are offered to farm and forest operations. The magnitude and importance of these and other pressures are unknown. Too much emphasis has been placed on the change in the initial dollar tax liability. In the long run, market forces will disperse this liability, though not evenly and without regard for any notions of equity. We need to know more about the ultimate impact of the reform proposals.

Some examples of important long-run changes that might be induced by market value assessment will be briefly analysed here. The viability of older downtown shopping areas is an important question for many smaller towns where these areas are threatened by newer shopping malls on the edge of town. Older downtown locations may have substantial tax increases when low current assessments are eliminated. The shopping malls face changes in the treatment of parking areas, which will raise substantially the cost of this land-intensive activity. Moreover, the assessment of individual parcels within the mall does not recognize the local monopoly rents being charged. Changes in this practice may increase mall operating costs. The net advantage created for malls or downtown areas cannot be determined but probably will vary geographically. For many smaller communities, the struggle to maintain a viable core is politically important, so that these tax effects need to be know.

13 Land viewed as excessive for residential purposes will bear taxes at full market value, as will vacant land.

A second example is the consequence of tax reform for single-family homes in various parts of cities, particularly older downtown areas. Sharply increased taxes will partially confer capital losses on owners of these properties and will increase annual operating expenses. For older owner-occupants, the cash flow problems might be severe, although the reform of the property tax credit should alleviate this difficulty. The increase in the relative price of land will tend to encourage conversion to multiple residency. Further decreases in the share of single-family units may be expected.

Next we consider the development and pricing of new residences. The increased assessments of land will further increase the market price of new houses and tend to increase the density of developments. In the short run, capitalization effects may reduce the price of land and speed up development, but in the long run the extra costs involved are unlikely to be shifted entirely to other markets. On the other hand apartments may be encouraged by lower taxes. In general, the price differences between old and new residences of any variety should be decreased as tax advantages based on age are eliminated.[14]

These are only three examples of broad policy questions raised by property reform that are of concern to municipalities. The magnitudes of the problems created by reform are not well known.

Property tax reform and grants[15]

A primary goal of the reform was the creation of an accurate current valuation of real property in the province. The market value of wealth in each municipality or local government jurisdiction might provide a useful base for local property taxes and for provincial grants, including payments in lieu of taxes. The Province has not limited its role to the provision of market value assessment and has become deeply enmeshed in the details of taxation itself. For the present it has remained extremely vague about grants. In view of the treatment of property taxation, the reformed

14 The time pattern may be complicated since the extent of capitalization is unknown. The existence of widely different effective tax rates is evidence that capitalization is imperfect.

15 The paper by Slack covers the grant reform in detail. This section simply emphasizes the interdependence of financing decisions for municipal expenditure.

grants program is likely to be tortuously detailed and improvised. The separation of the reform of grants and taxes as a practical matter has made it difficult to evaluate either.

The property tax reform would affect the independence and fiscal responsibility of municipal governments. For local governments, autonomy is increased if the grant reform shifts more grants to an unconditional form. The property tax reform would alter the grant base and consequently shift the revenue from existing grant programs among municipalities. It is unclear if these changes will be reversed or altered in the long run by grant reform.[16]

If the net effect of property tax reform on grants is unknown, this is particularly true of the effect of the increased provincial payments in lieu of taxes. For example substantially increased revenue will be received in areas in which farmland is a relatively important component of total local property. Yet the government produced data that held constant total provincial transfers, grants, and payments in lieu of taxes to all local governments. That implies transfers from non-farm areas to farm areas from the fixed total transfers.[17] Greater clarity is thus needed about the consequences of the reform on grants to municipalities.

Control and autonomy at the local level

In both political and economic theory there is a strong justification for local autonomy as a means of matching local desires for locally provided public services with the outputs provided and the taxes paid locally. The level of autonomy granted to local governments in Ontario is quite low compared to those in the United States, although not necessarily low compared to other provinces. The introduction of regional governments in Ontario has severely limited the role of lower-tier municipalities without bringing well-documented improvements. Unfortunately the property tax reform may strengthen further the role of the provincial government in local affairs.

The chief problem is not the choice of market value as the assessment

16 For 1980, grants will be based on market value assessment. The Province has promised that no municipality will lose grant money.

17 From the empirical material available to me, it is not possible to judge how this was done in the simulations of the alternative system.

base but the government's insistence on a common tax system everywhere in the province.[18] Under the existing tax system local property values adjusted to local assessment practices. Whether local assessments were fair or unfair, they did allow wide variations in the effective tax rate between properties in the same class and between classes. The reform proposals would make the effective property tax rate equal across properties in the same class.[19] Differentials in the tax rates across classes would be allowed in order to reduce the extremely large shifts in tax liabilities implied by a uniform effective tax rate across classes.[20] Unfortunately, the insistence on a uniform differential from equalized effective tax rates was the major reason for the failure of the recent reform efforts.[21] The provincial government was unable to devise a province-wide differential mill rate system that was politically acceptable.

The reform documents gave no serious consideration to allowing mill rate differentials across property classes to be established by municipalities; that is, the Province would establish the market value assessments in each municipality, and the municipality would decide on the mill rates that would be applied to each class of property. Municipalities would then be able to continue to use the present average effective property tax rates for each class or to shift to more equal effective tax rates. The government attempted to establish a system in which it alone decided the effective tax rate differentials. For example, under the Alternative System single-family residences would have had effective tax rates half those of industrial and commercial properties. If differential effective rates across property classes are going to be allowed, why not let the municipalities set them.

The political advantages of permitting local control might outweigh the

18 Unfortunately the public seems to blame market value assessment for the difficulties with the reform.

19 The inter-class variation in effective tax rates (defined as ratios of property taxes to market values) may be achieved in one of two ways: by varying mill rates or by varying ratios of taxable assessment to market values. For a discussion of the relative merits of the two alternatives, the reader is referred to the paper by Bossons.

20 Blair (22) estimated that in 1975 a uniform effective tax rate across property classes would have raised residential taxes by 26 per cent and lowered industrial and commercial property taxes by 40 per cent.

21 The current use of Section 86 of the Assessment Act is roughly equivalent to equalizing effective tax rates within classes at the existing average effective tax rate from each class.

theoretical reasons for it.[22] The Province could avoid having to find a compromise that mollified, imperfectly, the various local governments. Moreover, the political responsibility would rest with the municipalities, freeing the provincial government of any blame for the choices made locally. From the beginning of the reform process, it was known that some properties would be exempt and others, such as farms, would receive careful political handling. Most of the recent tax proposals are simply alternative tax schemes shaped to create the desired political impact. The Smith (1967) proposals, which suggested equalized effective tax rates including the business tax, seem truly revolutionary in relation to recent suggestions. Ironically, the Province's insistence on rigidly defining the local tax system has led it to become deeply involved in local details. Apart from the Province's unwillingness to give up power, it is difficult to understand the necessity of a uniform system throughout the province. I believe that the restrictions placed on expenditure choice by the grants program, together with the property tax system, leave far too little autonomy and diversity at the local level.

Suppose the local government could set mill rates for each property class. It would not be able to ignore the provincial and federal tax system or the provincial grants system when selecting the rates. Furthermore, local decisions will also be constrained by the expected reactions of private decision-makers. These obvious facts need to be stated because there has been talk of the 'irresponsible power' of local decision-makers.[23] I have not suggested any particular rate system, but for the sake of discussion let us assume that three mill rates exist. The three classes of properties could be single-family, apartments, and all others. Assume that the three mill rates are different for a given jurisdiction and that there are mill rate differences across jurisdictions. Incentives are created for altering location decisions and prices for existing properties, and the supply of new properties will be affected by any jurisidction. The provision of services across jurisdictions and property classes will also differ, affecting locational choices. The local decision-makers will have to foresee the probable consequences of their mill rate choices and adjust their de-

22 It is unlikely that political theory about the optimal size of jurisdiction will garner votes and alter political decisions.

23 These remarks seem to be based on the historical financial problems of the Depression but seldom appear in writing.

cisions accordingly. The consequences of poor decisions will be local. There may be some advantage to restricting the range of local mill rate differentials to eliminate the possibility of local groups with limited mobility being taxed very heavily. For example, a mining community might attempt to tax the rents from the mining company. Transitional effects are real but usually overemphasized. Local governments can be constrained at first to a range of differential mill rates across property classes. Once experience is gained, the constraints can probably be reduced.

There is only one serious problem with complete local autonomy. The Province seems to be determined to limit the important of benefits as an appropriate measure of tax liabilities. This implies that the net costs to municipalities will be positive for certain types of properties and negative for others. In particular, most non-residential properties have large negative net costs to municipalities. Municipalities have an incentive to compete for these properties using the property tax or services as an incentive, and total tax revenue may be lowered for this class of property. On efficiency grounds there is nothing wrong with this, but politically it will be undesirable. While I believe the benefit principle of taxation should not be suppressed, a consequence may be that some restrictions must be placed on local autonomy. However, they need not be as severe as they are at present.

THE CITY OF MISSISSAUGA: AN EXAMPLE OF MARKET VALUE TAXATION

Market value assessment was introduced in Peel, York, and other parts of Ontario a number of years before the provincial government took over the assessment function. In the late 1960s Peel County and the municipal governments within it shifted to market value assessment. The City of Mississauga is the largest municipality in Peel. In 1970 the Bureau of Municipal Research (1970) studied the effects of market value assessment on property taxes in the Town of Mississauga. Under the Peel Regional Government most of the Town of Mississauga is now part of the City of Mississauga. It is useful to recall briefly what was said in the Bureau's report in light of the proposed Alternative System.[24]

The Bureau's investigation confirmed that in all property classes the

24 The province-wide effects of the McKeough reform proposals are discussed below.

variance in the effective property tax rate was very large. The elimination of this variance in the effective tax rate is one of the reform goals discussed above. The introduction of market value assessment increased the share of taxes paid by residences and reduced that of commercial and industrial properties. Taxes on apartment buildings fell sharply. The study indicated that the differential undervaluation of land was responsible for a large portion of the variance in effective tax rates. This was true across property classes and within classes when age was introduced. There are reasons, however, why this conclusion may not follow from the evidence presented. But it is reasonable to presume that in most cases the land valuation of older properties is a major factor in the current system's distortions.[25]

The current provincial reform does not introduce market value assessment in the City of Mississauga. It updates the market value from 1969 to 1975 and alters the method of taxing at market value. Using data developed by the provincial government, it is possible to measure the increase in market value assessment during 1969-75.[26] Table 2, column 1, shows the percentage increase in the market value of certain property classes in the City of Mississauga. The spectacular changes in market value imply that the price grew at an average annual rate of 14.4, 11.3, and 7.2 per cent for single-family residences, industrial and commercial properties, and multiple residences respectively. The absolute price changes experienced during these years are obviously typical.

The very rapid growth in the prices of single-family homes in Mississauga in absolute and relative terms may also be observed in the rest of the province. The government had assessed all properties in the province at market value in 1971. The rapid increase in housing prices during the next three years upset the earlier reform timetable. Whatever commitment the government had to the taxation of residential properties at 100 per cent of market value collapsed. Residential properties would have to be taxed on a lower proportion of market value than other properties if the relative tax burden was not to shift sharply against single-family dwellings. The political cost of imposing these sharply higher taxes on

25 This suggests that a consistent reform effect will be a shift downward in the relative market prices of old versus new properties in all classes.

26 Note that properties built since 1969 are <u>included</u> in both sets of market valuations, 1969 and 1975.

TABLE 2

Increases in market value 1969-75 and changes in taxes under Alternative and Committee Systems in the City of Mississauga (percentages)

	Market value increase	Taxes	
		Alternative System 1976	Committee System 1977
Residential			
Single-family	124.1	-27.8	-17.0
Multiple residences	52.1	-49.0	-19.1
Commercial and industrial			
Finance and wholesale	76.4	13.7	32.1
Industrial	84.4	24.7	45.1
Professional and retail chain	93.6	16.5	35.4
Retail and commercial	91.4	8.0	25.0
Parking	150.4	46.9	70.5
All commercial and industrial	90.5	18.6	37.7
Land and vacant property			
Residential and commercial land	204.3	96.1	127.5
Vacant property	76.2	13.4	31.6

homeowners was unacceptable, a fact that reflects the ambiguities and lack of political conviction surrounding the usefulness of taxation at full market value. The Ontario government has never produced an adequate defence of the equity, efficiency, or political benefits of full market value taxation. It is not surprising that they have been unwilling to alter the weights. As suggested above, neither full market value taxation nor a province-wide fixed partial market value taxation have great economic or political logic.

If the current reform involved only an updating of market values, taxes would have been shifted towards single-family homes and land compared to all other properties and away from multiple residences compared to all properties. Those shifts would continue the ones that occurred when market value was first introduced in Mississauga. The recent rapid change reinforces the shifts in relative tax liabilities that are created by the introduction of market value. To counteract these price movements

and past assessment practices, the Province has recommended that residences be taxed at only 50 per cent of market value.

In Table 2 the percentage changes in taxes due to alternative tax systems reflect this reduction in residential taxation as well as many other changes. Both classes of residential property have large tax reductions, but the faster rate of price increase in single-family housing has substantially lowered the actual tax reduction based on 50 per cent of market value. The tax increases for industrial and commercial properties reflect the increases in the business tax rates. Only the retail and commercial class has no increase in business tax rates, and it has the smallest tax increase. The substantial increase in taxes on parking lots reflects the fact that land prices are rising more rapidly than total property prices. The rapid increase in land prices continues to outpace the growth in developed property prices.

Relative price changes will have a substantial effect on taxes paid across property classes. Using data from Peel Region, we can observe effects due to relative price changes across municipalities for the same property class. Table 3 shows the percentage change in market values during 1969-75 and in 1975 taxes for single-family and multiple residences. Within Peel, there are substantial relative price changes in single-family residences. The growth rate of prices ranges from a low of 13.7 per cent a year in the Town of Brampton to 21.6 per cent a year in the Township of Caledon. The relative price changes across municipalities might be due to errors in market value assessment at the two assessment dates. Evidence on the distribution of changes in the property tax in the City of Mississauga suggests that the errors in assessment were very small compared to the changes in market value.

For single-family residences, the ranking of municipalities by the rate of price change is almost identical to the ranking by tax reductions. This fact implies that the tax ranking is determined by the relative price change and not the change in the structure of the reform or shifts in the importance of different property types. In municipalities where market value has not been introduced, one cannot separate the consequences of recent inflation, the introduction of market value, and the structural reforms. We know, however, that the introduction of market value shifted taxes towards single-family residences and land and away from multiple residences and developed non-residential properties. We ought to observe that the introduction of the Alternative System in Peel would result in a

larger decline in Peel taxes for single-family residences and a larger increase in Peel taxes on developed non-residential properties. From Table 3 (and Table 4 below) we see that the 26.2 per cent drop in taxes on single-family residences in Peel is larger than that in the rest of the province. Similarly, Peel commercial and industrial properties have a larger property tax rise than either Metro Toronto or non-Metro areas. Similar tax changes would undoubtedly occur in all areas now using market value assessment. These areas have survived the initial impact of the move to market value assessment. An attempt to reduce taxes on residences by taxing at less than full market value would force these municipalities to absorb another sharp shift. For Peel business properties, the fall in taxes that accompanied the introduction of market value is being sharply reversed. The fluctuations in property taxes caused by these two changes increases the difficulties of planning investment decisions.

The evidence from the City of Mississauga and Peel Region suggests a number of conclusions. First, even in periods of rapid general housing price increases, substantial variations in relative housing prices have created sharp relative tax changes under market value assessment. One of the interesting unanalysed consequences of the reform is the long-run effects of relative price changes on the tax liabilities of different property groups. One does not know if the Province is willing to permit relative tax burdens to be changed through relative price changes across classes. Second, there is some concern that with continuous revaluations the growth elasticity of the property tax will become much closer to that of the income tax.[27] That is, revenue will grow substantially at fixed mill rates because of the rise in real estate prices. Local politicians would not have to vote for mill rate increases in order to raise funds. Actual tax payments have not been based on updated market value assessment in Peel. However, the data do suggest that the differential rates of market value increases in the area have not affected recent mill rate decisions.

There has not been sufficient analysis and reporting of the effects of market value assessment. Market value assessment has been used in parts of Ontario for almost a decade. Yet there are no thorough studies of the long-run, let alone short-run, effects in these areas.[28] It is sad

27 An example of this concern may be found in Provincial-Local Government Committee on Property Tax Reform (1978), 89-90.

28 The Bureau's study retains its stature partially because of the absence of alternatives.

TABLE 3
Changes in market value, 1969-75, and in 1975 taxes if the Alternative System had been introduced in Peel Region (percentages)

	Single-family		Multiple residence	
	Value	Tax	Value	Tax
Brampton				
Brampton	116	-31	62	-48
Town of Mississauga	173	-13	145	-21
Township of Chinguacousy	151	-20	61	-49
Township of Gore	185	- 1	151	-13
City of Mississauga	124	-28	52	-49
Caledon				
Village of Bolton	133	-28	99	-38
Village of Caledon East	172	-15	154	-22
Township of Albion	191	- 8	169	-15
Township of Caledon	224	2	216	0
Township of Chinguacousy	203	- 7	185	-13
Peel Region total	-	-26	-	-50

that the Province has not attempted to document the successes and troubles in these areas. The McKeough reform that failed politically did not entail more dislocation than has already been undergone by many municipalities. The Province failed to use the experience of Peel and other areas to smooth the introduction of market value assessment.

MARKET VALUE ASSESSMENT: LIMITATIONS IN PRACTICE

The measurement of the market value assessment base creates some interesting practical problems.[29] Actual market transactions will occur in only a proportion of real properties during any year, so that estimates of the market value of most properties will have to be made. This section discusses some of the limitations of the available estimation procedures.

29 I have been assisted in my understanding of the practical assessment problems by senior members of the Ontario government's assessment staff. Their help was very useful, but they do not bear any responsibility for my interpretation.

The Ontario government has made estimates of market values for 1971, 1975, and 1978. The experience provides some examples.

Assessment procedures: necessary deviations from current market value

The collection of assessment data on all real properties is an expensive task. Annual changes in the assessment data are not worth undertaking. In any year, the assessment data might be two to four years old; in 1983, for instance, property taxes could be based on market value assessments from 1979, 1980, or 1981. New properties will be added continuously, but complete annual revisions will not be feasible. In times of rapid price changes, rough estimates of market value assessment changes might be used.

Taxpayers must understand that the market value assessment is only an estimate of the market value of the property even during the assessment year. Market value means the sales price in a transaction between a willing buyer and a willing seller; market value assessment is an estimate that will differ from this sales price. These differences will probably be numerous and quite large. The selling prices of identical properties can vary substantially in a short period of time because of the high transaction costs and imperfect information in the housing market. Consequently market value assessments can never match market transaction prices but can only approximate some mean value of the transaction prices of identical properties. This fact causes no problems conceptually but has serious implications for appeal procedures.

The use of estimates of recent market values as the assessed values is readily understood by taxpayers. Most property owners will be able to compare their assessed value with their own estimate of the market value. They are not going to understand why substantial differences between these two estimates may exist. It will be necessary to explain maket value assessment to a homeowner who purchased a home in 1975 and discovered that his 1975 market value assessment is 10 per cent higher than the purchase price. With any of the methods used to assess properties at their market value, the assessed value may not equal the sales price even during that year.[30] The provincial assessment authorities will have to

30 The alternative are briefly discussed below.

make clear the fact that market value assessments are only approximate, not only for general communication to Ontario citizens but also for the legal basis of appeals. The committees that have studied the property tax reform have not discussed this issue extensively. Finnis (1977) emphasizes the problems in his review of the Blair report, and Mayor Munroe of West Carleton elliptically refers to problems in his municipality.[31]

One advantage of market value assessment, stressed by both Smith, (1967, III, 234) and Blair (1977, 9), is that market values are widely known. The difficulties of accurate assessment are not small. But market value can probably be estimated more precisely than any other kind of value. The differences between the estimates and particular transactions that remain will require explanation by the assessor. The high visibility of market value assessment makes the taxpayer honestly able to monitor his assessment, an important advantage over any other assessment base.

Assessment methods: general and particular

A number of methods are used in assessing real property. With all of them certain problems arise in interpreting market value.

There has often been strong practical disagreement about whether market value is to be interpreted as value in current use or value in best possible use.[32] This choice of wording is potentially misleading. Current market value should refer to a transaction between a willing seller and buyer. When it does, both current use and alternative present and future uses will be reflected in the price. Unfortunately, the precise relationship between market value and alternative uses, now and in future, cannot be easily established without considerable data. With market value assessment the real property market for most properties gives much information about the current interrelationship of alternative uses, present and future. The assessor must use this information to estimate the assessment on properties not sold in any year. If the market price in some geographical area and for some types of property reflects alternative current and future uses, their assessment will include these possibilities. There will be substantial

31 See his personal comments in Provincial-Local Government Committee on Property Tax Reform (1978).

32 The position taken by agriculture groups who wish to measure the productivity value of the land is an example. See the comments by Blair (43).

political pressure in agriculture and in other forms of changing land use to reject recent market evidence for properties that are in production and not on the market. This would be wrong if market value assessment is defined as the market price, as all recent proposals have done. It is sometimes suggested that zoning regulations be used to justify value-in-use in contrast to market value. This is incorrect, since the market price will already reflect current zoning practices as well as anticipated changes. The only sound principle is that information on trends in market prices should have priority in determining the market value assessment. Other information will have to be used too, but it should not be considered dominant unless either market prices are known or sound reasons exist for ignoring them. The latter is unlikely.

The second problem occurs relatively infrequently but produces many appeals per occurrence. Unique properties that are very valuable to the current user who is also the owner present special difficulties. If market value assessment implies a separate buyer and seller, as I believe it must, then attempts to tax the use value to unique users are mistaken. If it is done in these cases, we might try to assess every residence at the minimum price at which the owner would sell. This would imply a substantially higher assessment than the market value.

Assessment is now done by the provincial Department of Municipal Affairs. As a political and bureaucratic decision, assessment is carried out through a number of regional offices. With this structure, the experiments with computerized mass appraisal have been reduced, and this method will not be extensively used.[33] The Province experimented with these techniques for some years but has not made information available about their success in Ontario. The regional offices will depend on more traditional methods of combining the trends in sales prices, costs, and rents with characteristics of the property to produce assessed values.

For owner-occupied residential properties the prevalence of sales of comparable properties should provide sufficient information for the assessor to combine these data with any particular characteristics of the property. Since these properties are the largest group, we may sensibly hope that problems in this area should be small, although perhaps numerous.

33 Experimental use may continue, but full-scale calculation of assessment by computer will not be done.

More serious problems arise with properties where sales are not as common. For example most multiple residences are being assessed on the basis of gross rent capitalization. Information is collected on gross rents in the building, and these are multiplied by a number that represents the ratio of the capital or asset price to the rental price. There is very little public information on the correct number by which rents should be capitalized. Some American evidence from the 1970 U.S. Census of Housing suggests that the capitalization factor falls quite sharply with the size of the building. This method is also widely used for commercial and other rented space used by business. Evidence on the correct factor for these properties is weaker. The Ontario government has samples of properties sold in most important classes. This information has been used to derive the capitalization factors. Continued monitoring of the relationship between rents and sales prices is needed to ensure that changes in capitalization factors as well as changes in rents are captured in revisions to market value assessments. Provided sufficient sales price information can be collected to test the capitalization factors, the use of rents may not lead to major problems in stable areas. When the use of land is changing, market values will reflect this and current rents will not. Some effort must be made in these areas to adjust the capitalized rental value to account for alternative development in the future. It is not possible to tell how important this problem will be, but it is potentially serious and requires research to ensure that substantial tax revenues are not lost owing to undervaluation. To the extent that no adjustment is made, there will be an incentive for developers to hold land in uses with low current rentals for a longer period of time. Efficient land use choices will be distorted.

As a last resort, depreciated replacement costs may have to be used in assessment. This method should never be permitted to invalidate any relevant market price information. The market price can be very different from the replacement costs for older buildings. Construction techniques and materials have changed sharply with innovations and substitutions made to reduce costs. When this method is used in isolation from other methods, substantial errors are quite likely.

The Blair report (16) and the Smith report (71-6) both support the general comments made about alternative assessment methods. Since the market value assessments made by the Province are still secret, it is too

early to know precisely what methods have been used. When market value assessment is introduced, more open discussion of the problems and research requirements should become prevalent. Not only will this facilitate understanding and permit better research but it will also make possible an improved appeal procedure.

Appeal procedures

The Smith report devoted a chapter to the urgent requirements of improving the appeal procedures. Most of the discussion was devoted to the chaotic legal and administrative structure. These aspects of the reform will not be directly discussed here, though they are important. My limited comments on appeal concern more general conceptual and structural measurement problems.

It is perhaps trite to state that the appeal procedure should be open and inexpensive.[34] However with the new assessment base it is important that taxpayers perceive that they can appeal and expect judgments that are speedy and based on proceedings that they understand. The drafters of legislation must decide how precisely to define the meaning of market value and the type of evidence that will be permitted. Past experience suggests that neither the assessment branch of the government nor the judiciary should be allowed to define the conceptual and evidentiary basis of market value assessment. It would be useful if wide limits on evidence about market value were permitted and if some clear idea of the priority of different types of evidence were presented. Certainly all information relevant to the market value of the property must be allowed as evidence.

In this regard the Blair Commission recommended the elimination of Section 90 of the Assessment Act, which restricted evidence to comparable properties and limited appeals based on evidence from other properties. All restriction on evidence about market trends should be removed since such trends may assist in showing a pattern that is relevant to a particular property.

The strongest safeguards against assessments which are poorly related to market prices is the continued updating of the market value assessments. New approximations to market prices will constantly be used

34 A cost constraint must be maintained to eliminate frivolous appeals.

to adjust assessments. This should limit the cost of errors and reduce the value of appeals on small items. Continued research is necessary in those areas in which market price data are sparse, implying that weaker assessment methods are relatively important.

Underassessment of properties will not be appealed by the owner. Since other institutions such as the municipality may not have access to the required information, it is the Province's responsibility to use research results to minimize this problem. The problem may be most difficult for properties in transition. As these changes are forecast, market prices and market value assessment should reflect them. For a number of years a great deal will be learned by monitoring assessment and sales price changes for properties that change their use.

IMPACT INCIDENCE OF PROVINCIAL REFORM PROPOSALS

The long-run effects of introducing market value assessment cannot be quantified with the available evidence. The short-run impact, called the impact incidence, can be investigated. Short-run effects may be misleading as indicators of long-run changes, but events of the past few years show their political importance. The principles of tax reform did not seem to be received with either interest or concern by the general populace. Not surprisingly, the changes in tax liabilities were the important consideration. This section provides some evidence about the quantitative short-run impacts on various groups and regions, and an attempt is made to outline what appear to be the important political issues. The heavy reliance by politicians on the impact incidence is potentially erroneous; the possible overemphasis on short-run effects is commented on.

The quantitative comparison will be made using data on the current tax system, the proposals in McKeough's Alternative System, and the revisions to the latter suggested by the Provincial-Local Government Committee on Property Tax Reform (1978). Though the reform proposals were rejected, they represented the political outcome of substantial work. It is not likely that new reform efforts can ignore or substantially alter many of them. Most likely they will be gradually and partially introduced.

The Alternative System is a market value assessment system with wide implicit mill rate differentials.[35] All properties would be assessed at

35 As noted earlier, it was initially proposed in the form of differ-

market value. The mill rate for residences would be one-half that for non-residential properties. The business tax was reformed but not eliminated. Farms would be split into farm residential and non-residential property. The former would be taxed as a residence and the latter at a zero rate to the owner. The Province would pay all taxes on non-residential farm property at the non-residential mill rate.

The effects of the Alternative System have been estimated by the Ontario government for the year 1976. If total property tax revenue is held constant across the province, tax payments fall by 19 per cent on residences and are constant for industrial and commercial properties.[36] The tax decline in the residential classes is offset by a 60 per cent increase in taxes on other properties. Farms pay 46 per cent less, and the remaining groups face a tax increase of 83 per cent. In dollars, the increase in taxes on vacant land ($128 million), the federal government ($47 million), and Ontario Hydro ($28 million) constitute over 90 per cent of the total tax increase. For the whole province, the tax reform implies a substantial reduction in property taxes on farms and residences, no change for non-farm business, and enormous tax increases on the three groups mentioned.

On the surface, the province-wide impact seems politically admirable. Voters as residents have been promised a tax reduction. Farmers, who are politically important, have received substantial tax benefits in the past, and those are retained or extended. The major tax increases appear to fall on governments and their agencies or on holders of vacant land. But the simple total picture masks very different results once smaller geographical areas are considered.

Each municipality perceives the reform as a unique problem for its area. In fact the diversity of the impact by area cannot be easily summarized. To portray some of the major differences, let us contrast Metropolitan Toronto with the rest of the province. Under the Alternative System residences in Metro have a percentage tax decline that is only one-half that offered in the rest of the province. Business properties in Metro have tax cuts while taxes rise in the rest of the province. Other

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entials in the taxable portion of the market value assessment. This is logically equivalent to implicit mill rate differentials.

36 Unless explicitly stated, the business tax is included as a part of the property tax system. The data discussed include business tax revenue.

TABLE 4
Percentage changes in 1976 property tax payments under Alternative System

	Metro Toronto	Rest of province
Single-family residences	12.4	-16.0
Multiple residences	-42.9	-43.4
Subtotal	- 9.6	-21.9
Commercial and industrial		
Distillers	-40.5	-33.9
Financial, wholesale, and brewers	-18.3	0.9
Industrial	-11.6	- 0.4
Professional and retail chains	- 6.8	5.3
Retail	1.9	8.1
Parking	60.6	66.0
Subtotal	- 5.4	4.1
Farms	-	-45.8
Residential and commercial land	176.6	253.1
Vacant non-residential property	29.5	16.5
Lodges and clubs	40.8	38.5
Railways	71.5	95.6
Federal government	-21.6	82.5
Transmission lines	-19.8	-14.0
Ontario Hydro	39.7	-14.0
Municipal public utilities	-11.8	21.8
Subtotal	42.5	66.9

NOTE: Farms in Metro are unimportant.
SOURCE: Summary data for the Alternative Property Tax System, 31 January 1978

property classes will have much higher percentage increases outside Metro.

The percentage changes in tax payments by detailed property classes in Metro Toronto and the rest of the province are shown in Table 4. The striking problems within Metro are illustrated by the Metro subclasses. The Alternative System implied that taxes would increase for single-family dwellings in Metro by 12 per cent and by 22 per cent in the city of Toronto. Taxes on multiple dwellings would fall by 43 per cent in Metro and 30 per cent in the city of Toronto. Metro single-family residences are the only large residential group in the province whose taxes would increase substantially.

The enormous reduction in taxes on multiple residences throughout

most of the province was due to the decision to tax all residences on 50 per cent of the market value compounded with the higher effective tax rates on multiple dwellings in the present system.

The commercial and industrial sectors in Metro would have paid less taxes. This is true for almost all classes except parking lots, which would have faced substantial increases. For the rest of the province, commercial and industrial properties would have paid slightly higher taxes. Industrial financial, and retail properties face worse changes outside Metro. Farms are treated separately and discussed below. Non-farm land bears the brunt of the initial redistribution both inside and outside Metro. Various other groups face rising taxes outside Metro and a mixture of rising and falling taxes in Metro.

The severe impact of the Alternative System on Metro residences led the Provincial-Local Government Committee to propose a major reform. Large multiple residences would be taxes at 75 per cent rather than 50 per cent of their market value. This change reduces the average tax increase on Metro single-family residences to 9 per cent in 1977 from 12 per cent in 1976.[37] Similarly, the tax decline for large multiple residences is restricted to only 37 per cent. This is not a very significant change from the Alternative System. The Committee System does not alleviate the large differential impact of the Alternative System. A 30 per cent average differential change in single-family residences' taxes inside and outside Metro would remain.

For other property classes, the increased taxable assessment in multiple residences under the Committee System lowers taxes compared to the Alternative System. Since the direct effects on residential property are not large, the effects of the Committee System on other properties are fairly small.

Before proceeding to the business tax, consider the major contrasts implied by the reform. We defined the effective property tax rate ET as the property taxes divided by the market value. Under the current property tax system ET is much smaller for residential than for non-residential property. Within residential property it is smallest for single-family homes, followed by small multiple dwellings, and it is much bigger

37 The Provincial-Local Government Committee used 1977 mill rates and tax revenue, in contrast to the 1976 data used by the Province for the Alternative System.

for large multiple dwellings. Vacant land and farms have low ETs. Within the industrial and commercial sectors there are further variations in ET.

The introduction of a market value system with a uniform ET across all properties would have caused very large shifts between types of tax-paying properties. Since total tax revenue is held constant, single-family residences and small multiples would have had sharp increases in tax payments. The same would be true for vacant land, farms, and some other small groups. Large multiple residences and the industrial and commercial sectors would have lower taxes. These impact shifts would be too large to be politically acceptable. Moreover the commitment to market value assessment did not extend to a single ET. The Alternative System softened the impact of market value assessment by the use of less than 100 per cent of market value assessment for taxation of residences. In addition, changes in the business tax would be used to alter the effects.

Most early versions of the reform suggested that substantial changes should be made in the business tax. For example, the Blair Commission suggested a uniform business tax of 50 per cent of the property tax (Blair Report, 61; Smith Report II, 119). The Alternative System rejected this change. Instead, the business tax was used to minimize the tax decreases in the commercial and industrial classes. Distillers and industrial and financial businesses would obtain a substantial reduction in property taxes in the switch to market value. The declines would have been much larger if the business tax rate had been reduced to 50 per cent. For example, industrial properties are estimated to pay $14.9 million less in 1976 under the Alternative System. This decrease is due to the switch to market value assessment being offset by the rise in the business tax rate from 60 to 90 per cent. If the business tax rate had not risen, taxes on industrial properties would have fallen by $70 million. Implementing the Blair proposal of 50 per cent would have reduced the taxes on industrial properties further.[38]

The Provincial-Local Government Committee suggested that the introduction of a uniform business tax must not decrease the share of industrial and commercial properties in total tax payments. For 1977 this implied a flat business rate of 65 per cent rather than the 50 per cent

38 These dollar figures are not the final tax reducton. They are calculated assuming that the mill rate is unchanged. Changes in the latter would reduce the dollar declines.

suggested by Blair. This higher flat rate meant larger increases for the politically important retail and commercial property group. For this reason the flat rate was rejected.

For the province as a whole the adoption of the 50 per cent business tax would require that roughly $75 million in 1976 would have to be raised from all properties. This is the decrease, at existing mill rates, in tax collections under the Alternative System. Unfortunately, the larger share of this $75 million would have to be raised in Metro. Approximately $60.0 million in taxes are lost in Metro and only $15.7 million in the rest of the province. To raise this amount of money in Metro would require a tax rate increase of approximately two mills.[39]

In Table 5, the reduction in taxes for the industrial and commercial subclasses are shown for Metro and for the rest of the province. For distillers in Metro, column 1 states that taxes will be reduced by $0.8 million by the Alternative System. The use of a flat 50 per cent business tax (column 2) would reduce taxes for distillers in Metro by $1.4 million gross. In the rest of the province, taxes will be reduced by $2.5 million (column 3) under the Alternative System and by $3.5 million (column 4) with the 50 per cent business tax and the Alternative System. Columns 2 and 4 are gross changes that do not account for the redistribution of reduced business taxes to all property tax payers.

The refusal to move to the flat 50 per cent business tax imposed substantial costs on the first four industrial and commercial subclasses while minimizing the impact on the retail and commercial sectors. In political terms, these represent the largest and most important groups. The use of a flat business tax would impose significant additional tax liabilities on these groups in both areas of the province. The benefits would flow to groups with very little electoral power although with some political power. With the exception of industrial properties outside Metro, this group will have lower taxes, and the provincial government appears to be unwilling to grant immediately the large tax reductions implied by a reform of the business tax. Aside from general political reasons, the difficulties in Metro would be increased if the business tax reform was

39 In Metro Toronto 45 per cent of the decrease in taxes due to the uniform business rate would have to be raised from the industrial and commercial classes. The net reduction for this class in Metro would be closer to $33 million.

TABLE 5
Changes in 1976 tax liabilities for industrial and commercial properties due to the Alternative System and to a 50 per cent business tax ($ million)

	Metro		Rest of province	
	Alternative (1)	50 per cent business tax (2)	Alternative (3)	50 per cent business tax (4)
Distillers	- 0.8	- 1.4	- 2.5	- 3.5
Financial and wholesale	-15.0	-36.7	- 4.2	-10.4
Industrial	-12.0	-43.5	15.3	-51.6
Professional and retail chains	- 7.4	-17.0	- 7.0	- 1.4
Retail and commercial	2.6	24.1	14.8	41.3
Car parks	9.2	14.5	0.1	9.9

SOURCE: Same as Table 4

implemented. As Table 5 indicates, further shifts of tax liabilities to residences are likely if the business tax is set at a uniform 50 per cent.

The data support the conclusions that equalization of the business tax rate across properties or its elimination would exacerbate the shocks caused by market value assessment. Without a strong zeal for radical shifts in tax liabilities, reform of the business tax is an unlikely companion of market value assessment.

The political importance of the impact incidence in causing the failure of the reform can not be overemphasized. The insistence by the Province on a uniform geographic change in the property tax led to many specific and detailed concerns in each different municipalty about the sharp local changes in property taxes. Yet in Peel and many other smaller areas, market value assessment had been introduced without causing more than temporary disruptions. The provincial government seemed to lack the political will to inform municipalities and help them change the tax system to the new base. The general public was not well informed, and the provincial government misjudged the reaction to the new system. The policy for the early eighties seems to be to grope forward slowly, introducing various parts of reform in stages without any sharp break from the existing system.

With political judgments focused on the impact incidence, longer-run effects have been underrated or ignored. Existing distortions in the current system have predominantly been accommodated by buyers and sellers of real properties. However, the consequences of the current system continue to affect long-run land use decisions. The importance of longer-run effects needs to be discussed as the reform continues.

Farm properties

The Ontario farmer has received more than his share of comment and largesse in most versions of the reform. The situation is unique neither to Ontario nor to the property tax. Special treatment for agriculture is common in democracies.[40] The level of contention about the various suggested reforms of farm taxes has resulted in increasing vagueness as each new proposal surfaces. McKeough's Alternative System is ambiguous on most of the important questions. Farms are held by a sensitive and important group involved in a land-intensive business.[41] The market price of land in agricultural use has risen sharply in many areas. Farms have benefited from a variety of weak assessment practices and tax provisions such as exemption from the business tax. The introduction of market value assessment, with the non-residential mill rate excluding the business tax, would substantially raise farm taxes. Most proposals would sharply modify this impact.

The Alternative System would separate the market value assessment of farm residences and farm non-residential property. Farm residences would be taxed like all other residences at 50 per cent of their market value. Non-residential farm property would be taxed at market value with the taxes paid by the Province. Blair suggested that ten years' worth of taxes plus accumulated interest be collected when the property was taken out of agriculture.[42] McKeough did not accept this proposal and deferred any decision. It was suggested that recovery would be included in a

40 The ECC muddle on agricultural policy is an excellent example.

41 Special concern for other land-intensive businesses, e.g. golf courses and some resorts, is a symptom of the perceived inequity of market value taxation in land-intensive activities. More generally, it is part of a general dissatisfaction with a simple uniform property tax system of any kind.

42 See Blair (42-53) and compare with the Alternative System.

revised land speculation tax. Since the current land speculation tax is ineffectual it is very difficult to see any useful way in which recovery of taxes could be included in a revision of it. The Committee System proposed a complete giveaway of the tax revenue on farmland. The lack of any recapture was explicit. Aside from political strategy, there is very little reason for this. If the market value of a property is the current base for the tax, then the reform is offering enormous incentives to maintain land in farming through implicit lower mill rates on agriculture land.

I believe that use, not ownership, will be the relevant criterion for establishing property as farm property. Use will be measured by a minimum value of production, not of sales. For the existing farm rebate program the current production value is $2000 per property, although this figure is under review. The diversity of farm products and of the productivity of farmland makes it impossible to create a simple and uniform production value for farms. The 1971 Census of Agriculture reveals that the large percentage of farms with inadequate resources for commercial viability creates further problems. The Province and the Ontario Federation of Agriculture would like to exclude landowners who are not farmers from some of the benefits even if the land is used for farming, but this is very difficult to do using a production value criterion. If this value is set very high, the properties of a remarkable portion of farm owner-operators will not qualify as farms. Ontario, like the rest of Canada, has many marginal farmers whose numbers are too large for economic and political logic to ignore.

The farm reform proposals would provide an incentive for any business to argue that it is a farm business to avoid the property tax. The prime historical examples of 'property tax farms' are cheese factories and nursery activities. More important is the incentive given to non-farmer landowners to convert their property into farm (or forest) land.[43] It might not be very difficult for many landowners to qualify under the farm or forest provisions and consequently to avoid the impact of market value taxation on vacant land.

Within agriculture the provisions do not provide an incentive for more efficient agricultural production. For existing farm operators, the strongest incentives probably are offered to marginal farmers. Many subsidies

43 Forest land would receive tax treatment identical with farmland provided certain minimal conditions were met.

that operate through the market tend to benefit large-scale producers who sell most of their output on the market.[44] The farm non-residential property tax deferral or elimination will benefit farmers who operate at a very low level of total agricultural activity. Marginal farmers should be able to take advantage of this provision. There is no shortage of farm operators; in fact there is a surplus of them, and this provision will simply encourage small operators to stay in agriculture. If society wishes to alter the income distribution there are better ways to aid farmers (or other individuals) who have low incomes. In the case of farmers there is a need to assess total income carefully since a substantial quantity of non-farm income is earned by farmers and their families.

Since farm residences are to be taxed as residences there is an incentive for farmers to minimize the proportion of the property value that is designated as residential. While this separation is arbitrary, the method used should be clearly designated. The choice is between subtracting an estimate of either the value of farm non-residential property or the value of farm residential property from the market value of the whole property. To minimize the residential portion the first procedure should be chosen.[45] The Province has chosen the second procedure because the first would have meant that farm residential taxes would be very small.

Apart from minimizing political costs there is very little to be said for the current farm tax provisions. The impact on individual farmers will be enormously diverse. A new residential tax liability is created which is not a business expense. Federal and provincial income tax payments are affected by the loss of a property tax deduction. The price of agricultural land may rise, not fall, if landholding costs fall, and the supply of land used for agriculture may increase. The latter will further burden the provincial treasury. The long-run effects are largely unknown until the land speculation and capital gains provisions of these policies are clarified.

The discussion of the farm proposals is sufficiently succinct that the arguments have not been fully elaborated. Farms are important as an example of the impossibility of rapidly introducing a uniform market value

44 Marketing boards often attempt to prevent this, but they are not totally effective.

45 The value of Ontario farm properties in the 1970s was almost invariant to the existence of a residence on the property.

property tax. The land intensity of Ontario agriculture is increasing at a time when the market value for land reflects its potential for alternative use. At the same time the services provided by the property tax are not perceived by farmers to provide benefits commensurate with their costs. Since farmers are politically important, the resolution of the property tax reform for farmers provides an example of the difficulties that exist for many other groups that are not as important and are consequently less visible.

CONCLUDING REMARKS

Property tax reform in Ontario has not stopped. A large number of municipalities are revising their intraclass assessments using Section 86 of the Assessment Act.[46] Provincial grant programs will begin to change in 1980 to reflect market value assessment.

Ontario should move to market value assessment as the base for the property tax. It is the easiest to measure accurately and that reason alone is sufficient to choose it. While many measurement problems persist, any other measure of assessed value would be even less reliable.

The structure of the tax system that will be imposed on the new tax base remains uncertain. I have tried to suggest that there is no compelling practical or theoretical argument requiring a tax that is the same proportion of market value for all properties. The pattern of effective tax rate differentials before 1970 and the relative price changes during 1970-5 imply that no political party will introduce such a reform.

Two important issues remain unsettled. The first is the form of the differential effective tax rate system. To consolidate the reform and recover from strategic defeats, it may be necessary to accept existing differentials in order to introduce market value assessment. The changes in the differentials through time have two components. It may be decided that greater equality is required and consequently that a formal phasing-in of this relative equalization must be settled. In addition, future relative price changes across classes will affect differentials, and policy concerning relative price changes must be developed.

The relative roles of the provincial versus the municipal government

46 This procedure is discussed in more detail by Bossons's essay in this volume.

in deciding on the new tax structure is the final issue. At the moment (March 1980), there is little indication that the Province will delegate substantial power to the municipalities. However, the arguments for provincial control are not overwhelming, and this remains an important reform issue.

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Provincial-Municipal Grant Reform in Ontario

Enid Slack

INTRODUCTION

The need for reform of the provincial-municipal grant structure in Ontario was expressed over a decade ago when the Ontario Committee on Taxation (Smith Committee) stated that 'the situation with respect to provincial grants to local authorities in Ontario is - and we choose our word carefully - chaotic. It is not even possible to enumerate readily the grant programs currently in force' (Ontario Committee on Taxation 1967, II, 410). At that time the Committee made a number of detailed recommendations concerning specific grant programs. More generally, it recommended increases in provincial grants to reduce the burden of property taxes, and improvements in the co-ordination of grants by the Province. Subsequent increases in provincial grants and the transfer of some responsibilities for local services to the provincial level (for example, administration of justice and property assessment) reflected the desire of the Province to reduce local property taxes. However, the complexity of the grant structure remained unaltered.

Ten years after the publication of the Smith Committee report, the Provincial-Municipal Grants Reform Committee stated that 'the provincial-municipal grants structure in Ontario today is a $1.5 billion labyrinth' (Ontario, 1977, I, 1). This statement confirmed that very little had been done to restructure grants in Ontario in those ten years and that there was still pressing need for reform.

This paper describes and evaluates the current grant structure in Ontario and considers the recommendations for reform put forward by the Provincial-Municipal Grants Reform Committee.

The paper begins with a brief overview of the quantitative importance of provincial grants for local governments in Ontario.

In order to evaluate the effectiveness of grant programs in meeting their stated objectives, one must first consider those objectives. The next

I would like to thank Richard Bird, Don Dawson, Ron Kanter, and Michael Mendelson for comments on an earlier draft of this paper. I take full responsibility for any errors that remain.

section outlines a number of possible justifications for grant programs, including economic, political, and institutional considerations. Given these rationales, the appropriate grants are discussed to see whether they should be conditional or unconditional, matching or non-matching, open-ended or 'closed-ended.'

Next there is a detailed description of current grant programs in Ontario that classifies them according to the above characteristics. Also discussed in this section are the stated objectives of the grant programs.

The fourth section reviews the theoretical and empirical literature on the fiscal response of lower-tier governments to grants from upper-tier governments, considering each type of grant separately. Some observations are made concerning the likely impact of current provincial grants on Ontario municipalities and the consequences for provincial policy.

The fifth section summarizes and analyses the implications of the recommendations of the Provincial-Municipal Grants Reform Committee; it also evaluates the grant system and makes some suggestions for reform.

The concluding section briefly summarizes the major points in the paper.

COMPOSITION OF LOCAL GOVERNMENT REVENUES

The sources of revenue available to local governments in Ontario include property and business taxes, provincial grants, specific user fees, other miscellaneous revenues such as licences and parking fines, and borrowing. As can be seen in Table 1, provincial grants in 1978 accounted for 40.3 per cent of total local sector revenues (that is, revenues of school boards and municipalities combined). This percentage is somewhat higher for school boards (52.1 per cent) and considerably lower for municipal governments (31.6 per cent). Over the period 1975 to 1978, grants as a percentage of total revenues fell slightly, with a concomitant increase in the proportion of local revenues made up of property taxes.[1]

1 Property taxes as a percentage of total school board revenues increased significantly from 1975 to 1976. This is likely due to the large wage settlements with teachers in 1975 which led to expenditure increases beyond the expenditure ceiling. Since expenditures beyond the ceiling are financed through property taxes, this would likely explain the large increase in school taxes in 1975. Education grants will not be considered in this paper. For a discussion of the reform of these grants see Bird and Slack (1978b).

TABLE 1
Local government revenues, Ontario 1975-8

	1975		1976		1977		1978	
	$M	%	$M	%	$M	%	$M	%
Municipalities								
Taxation	1311	34.5	1470	33.1	1662	34.1	1785	34.6
Ontario grants	1276	33.6	1346	30.3	1525	31.3	1626	31.6
Specific user fees	495	13.0	600	13.5	625	12.8	725	14.1
Other revenues	414	10.9	500	11.2	598	12.3	749	14.5
Borrowing	306	8.0	530	11.9	461	9.5	267	5.2
Subtotal	3802	100.0	4446	100.0	4871	100.0	5152	100.0
School boards								
Taxation	1040	36.3	1297	40.6	1526	42.9	1663	43.5
Ontario grants	1659	58.5	1755	54.9	1908	53.7	1992	52.1
Other revenues	50	1.8	52	1.6	64	1.8	82	2.1
Borrowing	89	3.1	90	2.8	58	1.6	87	2.3
Subtotal	2838	100.0	3194	99.9	3556	100.0	3824	100.0
Taxation local sector								
Taxation	2351	35.4	2767	36.2	3188	37.8	3448	38.4
Ontario grants	2935	44.2	3101	40.6	3433	40.7	3618	40.3
Specific user fees	495	7.4	600	7.9	625	7.4	725	8.1
Other revenues	464	7.0	552	7.2	662	7.9	831	9.3
Borrowing	395	5.9	620	8.1	519	6.2	354	3.9
Total	6640	99.9	7640	100.0	8427	100.0	8976	100.0

NOTE: 'Other revenues' include such items as licences, fees, and parking fines.
SOURCE: Local Government Finance in Ontario (1977, 1978)

However, although provincial grants as a proportion of total local revenues have been falling since 1975, Table 1 shows that these transfers still represented a very significant portion of local government revenues in 1978. Given the magnitude of provincial grants, it is expected that they would have a significant effect on the expenditure and tax rate decisions of local governments. This point will be discussed more fully below.

Table 2 provides a breakdown of provincial grants to local governments and agencies in Ontario for the period 1976-7 to 1979-80 (estimated). General legislative grants for education are by far the largest component of total transfers, constituting over 54 per cent of total grants in 1978-9. Education is followed in quantitative terms by total unconditional grants, transportation grants, and social assistance grants, which account for 14, 14, and 6 per cent respectively of total transfers in 1978-9. An important point to note here is that unconditional grants, despite past proposals of the Ontario government to move towards greater use of them, still accounted only for 14 per cent of total transfers in 1978-9. The majority of grants continue to be conditional, with many strings attached to their use.

JUSTIFICATIONS FOR GRANT PROGRAMS

To evaluate the provincial-municipal grant structure in Ontario it is necessary to consider why grants should and do exist. The current programs can be evaluated in terms of their objectives.

The two main economic justifications for grants from upper-level to lower-level governments are derived from the theory of fiscal federalism. Grants are justified on allocative grounds (designed to affect the level or mix of expenditures) and/or on redistributive grounds (designed to achieve fiscal equalization among lower levels of government).[2]

On allocative or efficiency grounds it is argued that the provision of a particular service in a particular jurisdiction may result in spillover benefits (or costs) on residents of other jurisdictions. Because the jurisdiction providing the service only considers the benefits conferred on its own residents when it determines how much of the service to supply, spending on that service will be less than optimal. Where such external benefits exist, some sort of mechanism is required to encourage expansion

2 For a good treatment of the arguments which follow, see Oates (1972).

TABLE 2
Ontario payments to local governments and agencies ($ million)

	1976-7	1977-8	Interim 1978-9	Estimated 1979-80
Conditional payments				
General legislative grants	1693	1870	1969	2054
Transportation	443	490	503	537
Social assistance	162	183	212	228
Agriculture	56	57	61	61
Housing	42	37	34	45
Northern affairs	15	22	26	30
Environment	18	29	35	29
Culture and recreation	15	23	21	20
Health	14	13	18	17
Other	9	7	6	6
	2467	2731	2885	3027
Unconditional payments				
General support	97	109	134	149
Resource equalization	88	98	109	114
Per capita - policing	109	56	93	94
Per capita - general	98	42	76	77
Payments in lieu of taxes	40	45	47	50
Northern Ontario support	22	30	37	41
Other	25	18	15	18
	479	398	511	543
Payments to local agencies				
Children's aid societies	74	78	89	101
Homes for the aged	82	85	89	93
Health agencies	41	44	44	53
Conservation authorities	26	30	34	32
Library boards	20	22	22	23
	243	259	278	302
Total financial transfers	3189	3388	3674	3872

SOURCE: Ontario Budget 1979, Budget Paper C, p. 28

of the activity to account for these external effects. A subsidy to the jurisdiction generating the spillover, equal to the value at the margin of the spillover benefits, would achieve this goal.[3] The type of subsidy re-

3 An alternative to the grant would be amalgamation of the two jurisdictions referred to in the text. This would internalize the spillover. However, this solution becomes more complicated when there are more than two jurisdictions involved and more than one service for which there are spillovers.

quired is an open-ended matching grant where the donor pays a certain percentage of the expenditures on that service and there is no limit to the amount of the grant. The matching rate (the percentage of expenditures) would represent the ratio of external benefits to total benefits. For example, if one-fifth of the total benefits of the service spill over into other jurisdictions, then the matching rate would be 20 per cent; the donor government pays 20 per cent of the expenditures on that activity, and the recipient government pays the remaining 80 per cent. By altering the price of the service to the lower level government, an incentive to expand the service is provided.

A second rationale for intergovernmental grants, as stated above, is on grounds of equity, or equalization of fiscal capacity, defined as the ability of governments to raise revenues. The objective is to allow each jurisdiction to provide some 'average' level of services by exerting an 'average' fiscal effort. For this purpose, unconditional, lump sum transfers are recommended. These grants usually vary with some measures of need and fiscal capacity but do not require any particular response on the part of the recipient.

In addition to the economic reasons for grants, there may be several other reasons. Unconditional transfers are often justified on the grounds that senior levels of government have greater revenue-raising capabilities than their lower-level counterparts. It has been stated that central governments have the capacity for a more progressive revenue structure and the ability to take advantage of economies of scale in tax administration. Also, lower-level governments often experience a mismatch of revenues and expenditures whereby their expenditure demands rise more quickly than their revenues (at existing local tax rates). Unconditional grants from an upper tier allow local governments to take advantage of a more highly elastic revenue source so that the growth in expenditures can be matched by the automatic growth in revenues.

Although grants are often justified on these grounds, there may be better ways to solve the problem of a mismatching of revenues and expenditures. For example, lower-level governments could be provided with additional revenue sources (sales tax, income tax, and others); there could be more adequate revenue-sharing with upper-level governments; or certain expenditure functions could be transferred to another level of government. Grants may not be the best way to meet expenditure requirements.

It has also been argued that grants can be treated as 'the price of traded functions' (Breton and Scott 1978). Those levels of government with surplus tax revenues are assumed to enter an imagined trade as buyers of 'expenditure functions,' while those with inadequate tax revenues enter as sellers. The authors predict a shift of powers to the level with the most productive tax bases, that is, the central government. The payments for these functions can take several different forms including conditional or unconditional transfers. The type of grant depends on the interaction of the politicians and the bureaucrats. Politicians who are giving the grants are indifferent to the type, but their bureaucrats tend to prefer conditional grants because they involve higher co-ordination and administration costs and thus require the services of bureaucrats. Politicians who receive grants prefer unconditional ones because they allow greater flexibility, but again their bureaucrats prefer the more administratively complex conditional grants.[4] Breton and Scott conclude that the donors would give in to bureaucrats' wishes and opt for conditional grants, whereas the recipients, preferring greater flexibility, would not indulge their bureaucrats and would thus prefer unconditional grants.

As with the previous rationale for grants, it can be argued that there are other ways to compensate for surplus revenues at one level of government and inadequate revenues at another level. Also, if it is the case that bureaucrats like conditional grants because of the need for greater administration, as Breton and Scott argue, one wonders why these bureaucrats would not make efforts to take over the function entirely and administer it themselves. This argument about the interaction of bureaucrats and politicians does not really provide an adequate explanation for conditional grants as such.

In addition to those justifications for grants, some political-institutional arguments have been mentioned. It has been argued that upper-level governments want both to have local governments provide their own services and to maintain control over how the money is spent and also

4 It is unclear that bureaucrats in the donor government want to increase co-ordination and administration costs by using conditional grants. Mendelson shows, for example, that the provincial costs of administering municipal welfare were about $550 000 in 1975-6 (and have been falling in real terms) compared to about $27 million at the municipal level (see Mendelson 1979, 102).

establish certain minimum levels of these services (see, for example, Gramlich 1976). One instrument for achieving this dual purpose is conditional matching grants which are 'closed-ended' (that is, have a limit on the amount of funds available). In this way the donor government alters the price of certain services to the recipient governments, thereby encouraging spending on functions designated by the upper level. By making these grants closed-ended the donor government is also able to control the amount of money it gives out in grants. Schultze (1974) argues that grants can be thought of as a device whereby local governments act as agents or contractors for the donor governments in carrying out specific tasks. As will be shown below, this is the most likely justification for provincial-municipal grants in Ontario.

Other justifications for transfers are provided by Schultze (1974) in considering social grant programs. These include, in addition to the objectives described above, such goals as the transfer of some goods to target low-income groups, spreading innovations in the delivery of public services on the grounds that there are significant externalities in research and development, speeding labour force supply responses (through training grants for specific kinds of skills), improving the flow of information, and increasing the bargaining power of the poor and minorities at the local level. In summary, grants most likely exist because lower-level governments face a mismatch of revenues and expenditures and because donor governments want the recipients to run their own programs while still retaining control over the expenditures.

GRANT PROGRAMS IN ONTARIO

There are approximately ninety different grant programs from the Province to municipalities, boards, and commissions in Ontario. Some grants go to municipalities directly, while others go to the various municipal boards and commissions. Each provincial ministry that administers grant programs has different rules and procedures which have to be followed in order to receive the grant. Most grants are governed by corresponding Acts and often lengthy Regulations. Within a particular grant program, formulas often vary according to the specific circumstances of the recipient municipality. Almost every grant has some unique feature, whether it is the formula used, the conditions imposed on the recipient, or other rules and

regulations. This makes any meaningful classification of these grant programs very difficult, but an attempt to do this is made in Table 3 and in the remainder of this section.

Grants can be broadly grouped into unconditional and conditional, depending on whether any restrictions are placed on the use of the funds. The stated objectives of the provincial government are to give greater assistance to the municipalities with greatest financial need through unconditional grants and to use conditional grants to encourage municipal spending on specific services (Ontario 1975, xv). As noted in an earlier section, conditional grants provide the majority of grant funds to municipalities in Ontario.

Unconditional grants place no restrictions on how the money may be spent. However, an important distinction can be made between grants which are unconditional with respect to how they are used and grants which are unconditional with respect to how they are received. In other words, some supposedly unconditional grants require the recipients to meet a number of conditions before they can be eligible for the grant, even though there are no restrictions on how the money is spent. An example is provided by the per capita police grant (see Table 3), which is a component of the unconditional grants package that depends on the municipality providing its own police force. Although this grant does not specify where the money has to be spent (it is unconditional regarding use), it does specify certain behaviour on the part of the municipality in order to receive the grant (it is not unconditional regarding receipt). The report of the Provincial-Municipal Grants Reform Committee describes the police per capita grant as 'an unconditional per capita grant which identifies municipalities which incur police costs' (Ontario 1977, 182). It goes on to suggest that the reasons for the higher per capita grant rate for municipalities with a regional force reflects the Province's objective of encouraging establishment of regional forces in regional municipalities (ibid.) This sounds very much like the previously stated objective for <u>conditional</u> grants. Interestingly, earlier supposedly unconditional grants were also often given for specific services, such as police and fire services in 1949, social services in 1954, and hospitalization of indigents in 1964.

The importance of this distinction concerning use and receipt of grants is that an unconditional grant which depends on certain services

TABLE 3
Classification of provincial-municipal grants in Ontario, 1979

Name of grant	Basis of assistance	Category									Comments
		Conditional	Unconditional	Matching	Non-matching	Open-ended	Explicitly closed-ended	Implicitly closed-ended	Capital	Operating	
I Unconditional grants											
General per capita grant	Per capita grant depends on size of population, with large municipalities receiving larger grants	x	-	-	x	-	x	-	-	-	
Police per capita grant	An amount per capita if municipality provides own law enforcement or under contract with OPP	-	x	-	-	x	-	x	-	-	Unconditional re use; conditional re receipt Committee recommends elimination
Density per capita grant	An amount per capita varying inversely with population density	-	x	-	-	x	-	x	-	-	Committee recommends elimination
Resource equalization grant	Grant based on relative assessment deficiency of municipality and net general dollar levy.	-	x	-	-	x	-	x	-	-	Matches resources
General support grant	Grant provides percentage of net general dollar levy	-	x	-	x	-	-	x	-	-	Matches resources
Special support grant	Grant provides additional percentage of net general dollar levy for municipalities in Northern Ontario plus some others	-	x	-	x	-	-	x	-	-	Matches resources
II Conditional non-matching grants											
Children's Aid Societies - capital grants special	Payment equal to cost of new building, addition, or acquisition of building	x	-	-	x	-	x	-	x	-	Committee recommends elimination when re-

Children's Aid Societies - operating cost re: unorganized territory	Payment for operating costs of a society for care of children in unorganized territory within its jurisdiction.	x	-	-	x	-	-	x	-	x	sponsibility transferred to municipalities
Homemakers instruction	Payment for approved costs of course of instruction	x	-	-	x	-	-	x	-	-	
Homes for the Aged - maintenance	Payment of net cost of maintaining persons formerly in unorganized territory	x	-	-	x	-	-	x	-	x	
Municipal and County Public Library Boards	Per capita grant	x	-	-	x	-	-	x	-	-	Committee recommends elimination
Regional Library System Boards	Grant based on population and area of region plus a special grant	x	-	-	x	-	-	x	-	-	
Public Libraries for Indian Bands	Per capita grant	x	-	-	x	-	-	x	-	-	
Venereal Disease Clinic	An amount per clinic attendance	x	-	-	x	-	-	x	-	-	
Ontario Home Renewal Program (OHRP)	Per capita grants	x	-	-	x	-	x	-	-	-	
Fires on Crown Lands within Fire Regions	Total cost	-	-	-	x	-	-	x	-	-	
Livestock compensation	Compensation for losses caused by wolves	x	-	-	x	-	-	x	-	-	
III Conditional matching grants											
Drainage works	Percentage of cost assessed against agricultural land.	x	-	x	-	-	-	x	x	-	
15% Grants for major works	Percentage of capital cost for water supply and sewage works	x	-	x	-	-	-	x	x	-	
Grants and loans to small municipalities for high cost projects	Percentage of net project cost	x	-	x	-	-	x	-	-	-	
Grants for the repair or reversal of private water and sewage systems	Percentage of costs	x	-	x	-	-	-	x	-	-	
Community Services Contribution Program	Percentage of eligible project costs	x	-	x	-	-	-	x	-	-	

TABLE 3 (continued)

Name of grant	Basis of assistance	Category									Comments
		Conditional	Unconditional	Matching	Non-matching	Open-ended	Explicitly closed-ended	Implicitly closed-ended	Capital	Operating	
Children's Aid Societies - capital grants, general	An amount up to 25 per cent of building and land.	x	-	x	-	-	-	x	x	-	Committee recommends elimination when responsibility is transferred to municipalities
Children's Aid Societies - operation cost	Percentage of approved operating costs of society	x	-	x	-	-	-	x	-	x	
Day Nurseries - capital construction costs	Percentage of costs of new buildings computed in accordance with regulations plus percentage	x	-	x	-	-	-	x	x	-	Committee recommends capital grants be suspended pending review
Day Nurseries - operating costs	Percentage of costs computed in accordance with regulations	x	-	x	-	-	-	x	-	x	
District Welfare Administration Boards - initial operation	Percentage of estimated expenditures of the board for the year	x	-	x	-	-	-	x	-	-	
General Welfare Assistance - supplementary aid	Percentages of assistance granted	x	-	x	-	-	-	x	-	-	
Special Assistance	Percentage of amounts paid to or on behalf of a person in need of special assistance	x	-	x	-	-	-	x	-	-	
Welfare services - administration and other costs	Percentage of cost of the administration of welfare services as defined in the regulations	x	-	x	-	-	-	x	-	x	
Municipal Bilingualism Program	Percentage of costs	x	-	x	-	-	x	-	-	-	
Conservation Education	Percentage of assistance for education programs	x	-	x	-	-	-	x	-	-	

Airports	Percentage of construction and maintenance costs	x	-	x	-	-	-	x	-	-	
Local Heritage Markers	Percentage of approved project cost	x	-	x	-	-	x	-	-	-	
Homemakers and Nurses Services	Percentage of amount by which total monthly cost of approved services paid by municipality exceeds available monthly income of person in need, in accordance with Regulations	x	-	x	-	-	-	x	-	-	
Homes for the Aged - acquisition or alteration of an acquired building - additional furnishings and equipment	Percentage of cost of acquiring, altering, furnishing, and equipping building - also cost of additional furnishings that are not replacements	x	-	x	-	-	-	x	x	-	
Homes for the Aged - building or extending	Percentage of actual cost	x	-	x	-	-	-	x	x	-	
Homes for the Aged - maintenance	Percentage of approved net cost for residential care	x	-	x	-	-	-	x	-	x	
Homes for the Aged - residential services	Percentage of costs, approved by the director, of providing or purchasing residential services	x	-	x	-	-	-	x	-	x	
Homes for the Aged - extended care services	Percentage of basic rate in effect on a per diem basis plus any part of cost that exceeds ceiling	x	-	x	-	-	-	x	-	x	
Elderly Persons Centres - capital grants	Varying percentage of costs of erection, alteration, extension, acquisition, furnishing and equipping, computed in accordance with Regulations	x	-	x	-	-	-	x	x	-	Committee recommends elimination
Elderly Person Centres - operating and special program grants	Percentage of net monthly expenditure determined in accordance with regulations up to a ceiling	x	-	x	-	-	x	-	-	x	Committee recommends elimination
Land Titles Survey Fund	Percentage of total survey costs	x	-	x	-	-	-	x	-	-	

Name of grant	Basis of assistance	Category									Comments
		Conditional	Unconditional	Matching	Non-matching	Open-ended	Explicitly closed-ended	Implicitly closed-ended	Capital	Operating	
Community Programs of Recreation	Percentage of salaries of varions employees plus percentage of approved maintenance and operating costs snbject to a maximnm	x	-	x	-	-	x	-	-	x	Committee recommends elimination
Community Recreation Centres	Percentage of approved costs up to a maximum	x	-	x	-	-	x	-	x	-	Committee recommends elimination
Museums - development	Percentage of approved project costs up to a maximum	x	-	x	-	-	x	-	x	-	Committee recommends elimination of all grants to museums owned by municipalities
Museums - establishment	Percentage of establishment cost net of sums received from other provincial or federal agencies	x	-	x	-	-	x	-	-	-	
Museums - maintenance	Percentage of annual salaries of curator and assistants plns percentage of net receipts plus excess of gross receipts over preceding year over grant paid, all of the above up to a maximum										
Local Roads Boards - territory without municipal organization	Percentage of cost	x	-	x	-	-	-	x	-	-	
Ambulance services	Varying percentage of costs as approved by Minister	x	-	x	-	-	-	x	-	-	

Boards of Health	Percentage of expenses varying with nature of recipient	x	-	x	-	-	-	x	-	-	Committee recommends that Boards of Health as special purpose bodies be eliminated
Community health facilities	Fraction of approved costs of the building project	x	-	x	-	-	-	x	-	-	
Venereal Disease Physician's Account	Percentage of amount that would be payable by insured health services	x	-	x	-	-	-	x	-	-	
Grants for hospital construction + extra grants for Northern Ontario	Fraction of approved costs of construction professional fees and necessary basic equipment	x	-	x	-	-	-	x	x	-	
Neighbourhood improvement program	Fixed percentage of eligible costs	x	-	x	-	-	-	x	-	-	Committee recommends elimination
Parks Assistance	Varying percentage of total cost of acquisition and development to a maximum	x	-	x	-	-	x	-	-	-	Committee recommends elimination
Recreational Development and Acquisition of conservation areas	Percentage of assistance for acquisition development	x	-	x	-	-	-	x	-	-	
Conservation areas	Percentage of costs of purchase and development of approved land	x	x	-	-	-	-	x	-	-	Committee recommends elimination of administration, operation, and maintenance grants
Water control study	Percentage of cost of engineering studies	x	-	x	-	-	-	x	-	-	
Water control structures	Percentage of construction costs plus percentage of maintenance costs	x	-	x	-	-	-	x	-	-	
Surveys, co-ordinate control	Cost sharing arrangement	x	-	x	-	-	-	x	-	-	
Land for forestry purposes	Varying percentage of purchase price as legal fees, as approved	x	-	x	-	-	-	x	-	-	
Police radio communications services	Percentage of approved activity	x	-	x	-	-	-	x	-	-	
Roads, bridges, and culverts	Percentage of construction and maintenance varying by type of municipality	x	-	x	-	-	-	x	-	-	Committee recommends elimination

TABLE 3 (continued)

Name of grant	Basis of assistance	Category									Comments
		Conditional	Unconditional	Matching	Non-matching	Open-ended	Explicitly closed-ended	Implicitly closed-ended	Capital	Operating	
Suburban roads	Percentage of road and bridge construction and maintenance; higher percentage if felt municipal financial capability warrants it	x	-	x	-	-	-	x	-	-	
King's Highway connecting links	Percentage of cost of eligible items of construction and maintenance varying with type of municipality	x	-	x	-	-	-	x	-	-	Committee recommends elimination for municipalities of more than 5000 population
Development roads	Varying percentage of construction and maintenance costs	x	-	x	-	-	-	x	-	-	Committee recommends elimination
Statute Labour Boards and Groups - territory without municipal organization	Percentage of statute labour work on roads, bridges and culverts	x	-	x	-	-	-	x	-	-	
Sidewalks on King's Highway or county road	Varying percentage of the cost of work	x	-	x	-	-	-	x	-	-	
Municipal transportation planning	Varying percentage of cost, by agreement with the Minister	x	-	x	-	-	-	x	-	-	Committee recommends elimination
Transportation	Percentage of subway; construction expenditures, cost of buses, trolley, transit terminals etc. and percentage of operating costs based on population	x	-	x	-	-	-	x	-	-	

Involvement in municipal administration	Percentage of student's weekly salary up to a maximum	x	-	x	-	-	x	-	-	-

IV Unclassified conditional grants

Heritage conservation	By agreement, as approved by the Directors of the Ontario Heritage Foundation
Community Planning study grants	Each application is reviewed on an individual basis
Access roads to provincial parks	By agreement with the Minister
Fire in Fire Regions	By agreement
Municipal surveys	Subject to negotiation
Housing development study grants	Depend on extent of development
Municipal housing statement grants	Each grant considered on its merits
Grants-in-aid of publication	Approved by Ontario Heritage Foundation
Waste Management Area Planning Studies	Administered by Waste Management Branch

NOTE: 'Committee' refers to the Provincial-Municipal Grants Reform Committee. This table was derived from information in Ministry of Treasury, Economics and Intergovernmental Affairs (1979).

being provided will likely alter the expenditure priorities of the municipality. In other words, a grant given for a particular service will, other things equal, encourage municipalities to provide that particular service. The impact of a grant of this sort on the behaviour of the municipality is similar to that of a conditional non-matching grant (see below), and the Province in large part determines this behaviour.[5]

Conditional grants (groups II and III in Table 3) can be broken down into non-matching grants (group II) and matching grants (group III). A matching grant is one in which the Province offers to pay a specified percentage of expenditures made on a particular function. For example, in 1977, the Province offered to pay 80 per cent of operating costs for day nurseries; the remaining 20 per cent was to be raised locally. Non-matching grants are lump sum transfers that do not require any funds on the part of the municipality. An example for 1979 was the grant for municipal and county public library boards whereby the Province paid an amount equal to $1.80 per capita multiplied by the population of the municipality or municipalities for which the library board was established. The majority of conditional grants in Ontario, as can be seen in Table 3, are of the matching variety.

Grants are also open-ended or closed-ended where open-ended grants do not specify an upper dollar limit on the amount of grant funds available. In some cases, grants are explicitly closed by an actual dollar limit placed on the amount a municipality can receive. For example, the grant for community recreation centres in 1977 was 25 per cent of approved costs up to a maximum of $75 000 per facility. There are also other methods whereby the Province can limit the amount of funds it gives out in transfers. For example, the minister can restrict expenditures on the project or alter certain aspects of the project in the approval process. This implicitly places an upper limit on grants for that program. Ministerial approval is usually required for capital projects. Also, the Regulations governing receipt of the grant often define those costs eligible for grants where they may be less than total costs. In this way grants are restricted by the

5 Some other components of the unconditional grant package are truly unconditional. For example, grants based on population do not require any particular behaviour on the part of the municipality. In other words, there is little a municipality can do to alter its population at a given point in time and thereby affect the amount of grant it receives.

Province. This latter category appears in Table 3 as 'implicitly closed.'

The final category which appears in Table 3 shows that grants are sometimes designated for capital purposes or for operating purposes. For example, there is a grant for Elderly Persons Centres which pays not in excess of 30 per cent of eligible capital costs computed in accordance with the Regulations. On the other hand there is a grant for Homes for the Aged which pays 70 per cent of approved costs for maintenance. Subsidization of a particular input, under certain assumptions, will result in greater use of that input and will alter the production process. Many grants, however, do not specify whether they are to be used explicitly for capital or operating purposes.

There are also some grants (group IV in Table 3) which could not be classified because they vary for each individual grant and are 'as designated by the Minister.'

Although the structure of provincial grants to municipalities in Ontario is thus very complicated, some important general observations can be made. Grants in Ontario are almost all conditioned by something. With the exception of the unconditional grants and a few of the conditional grants, most grants are matching. Few grants have specific dollar limits on the amount of funds the municipality can receive, but most are closed-ended to the extent that restrictions implicitly provide upper limits.

Two major points should come out of the above discussion. First, the provincial-municipal grant system in Ontario is the labyrinth described by the Provincial-Municipal Grants Reform Committee. An attempt has been made here to fit programs into general classifications, but Table 3 hides much of the complexity of the grant system which results from the unique features of each of the over ninety programs. The implications of having such a complex grant structure will be considered below. The second point is that the majority of grants have conditions and involve significant provincial control over municipal expenditure behaviour. This control is exerted by definitions of eligible costs, by imposing copious rules and regulations, and by altering the price of certain services to the municipality. As an extreme example, it is not clear whether municipal welfare assistance is a municipal program being subsidized by a provincial grant as stated or whether it is really a provincial program being partly administered by municipalities.[6] Again, the implications of significant provincial

6 The Provincial-Municipal Grants Reform Committee recommends that the

control will be evaluated below.

As for the justifications for grant programs, some further points can now be made. It was argued earlier that grants which are designed to account for spillover effects should be conditional, matching, and open-ended where the matching rate reflects the ratio of external benefits to total benefits. Although many of the provincial grants to municipalities in Ontario are conditional and matching, very few are open-ended. Some have dollar limits, while the majority have other methods of limiting grant funds, such as detailed rules and regulations which must be followed. Also, many of these grants are characterized by very high matching rates (in the range of 80 to 90 per cent of expenditures) which would tend to suggest, under the spillover theory, that most of the benefits of these programs spill over into other jurisdictions; this is not likely the case. The combination of very high matching rates and the closed-ended nature of conditional matching grants in Ontario suggests that the rationale of dealing with jurisdictional spillovers may not adequately describe the current grant structure in Ontario.

It can be recalled that the second rationale for intergovernmental transfers was the equalization of fiscal capacity. There are a few unconditional grants programs in Ontario based on population (a measure of need) and the assessment of the municipality compared to the average for the province (a measure of fiscal capacity) which attempt to do this. For example, the resource equalization grant matches the resources of the municipality (measured as net general dollar levy). The matching rate is determined as some fraction of the assessment deficiency of the municipality compared to the provincial average per capita assessment.[7] Only those municipalities whose assessment base per capita is below the pro-

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Province assume full financial and administrative responsibility for general welfare assistance to employable persons and assume full financial and possibly administrative responsibility for unemployable persons on the general welfare assistance caseloads (Ontario 1977, 137-42).

7 The formula for the revenue equalization grant for 1979 can be represented as follows:

$$REG = 0.6 \frac{(10\,800 - EAVpc)}{10\,800} NGDL,$$

where 10 800 is the provincial average per capita equalized assessment, EAVpc is the per capita equalized assessment of the municipality, and NGDL is the net general dollar levy.

vincial average are eligible to receive this grant. This means that the grant partially equalizes fiscal capacity up to the provincial average. Unconditional grants do not require any response on the part of the recipient municipality, but they may require certain behaviour before they can be received. Although the stated objective of the provincial government is to use unconditional grants to give greater assistance to the municipalities with greatest need, these unconditional grants are based on inadequate measures of need and fiscal capacity (see below).

The argument that donor governments want municipalities to provide their own services but at the same time to ensure minimum service levels seems more appropriate to Ontario. It was argued that the best way to achieve these goals was through the conditional, matching, closed-ended grant. These grants constitute the vast majority of provincial-municipal programs in Ontario. This is consistent with the Province's own statement that conditional grants are used to encourage municipal spending on specific services.

In Ontario the main justification for grants to municipal governments seems to be political and institutional rather than economic, with the exception of the unconditonal grants package. Unconditional grants, though, only accounted for 14 per cent of the total in 1979 anyway. Apparently the province wants to encourage spending on particular services which it deems important, and it does this by placing significant controls on municipalities through the grant structure. This has resulted in ninety different grant programs with many strings attached.[8] The provincial ministries are not interested in removing these strings because 'they have some vested interest in keeping them' (Ontario Economic Council, 1978, 25).

IMPACT OF GRANTS ON BUDGET DECISIONS OF LOCAL GOVERNMENTS

In designing a grant program to meet objectives such as those enumerated above, it is important to know the impact of any particular grant on the budget decision-making of the recipient municipality. A vast theoretical and empirical literature has developed to determine the fiscal response of lower-tier governments to various types of intergovernmental transfers. This section briefly examines the results of these studies.

8 This should come as no surprise (see Bird 1978, 92).

The early 'determinants' studies (see Sacks and Harris 1964, Kurnow 1963, Brazer 1959, and several others) statistically estimated the effect on local expenditures of a number of independent variables such as income, population, population density, percentage of the population living in urban areas, and intergovernmental transfers.[9] The results, usually based on cross-section data for state and local governments in the United States, generally indicated that grants have a significant impact on the expenditures of the recipient government. However, the magnitude of the response differed, depending on the study: some studies found that a dollar increase in grants to local governments resulted in less than a dollar increase in expenditures (and presumably a decrease in taxes), while others found a dollar increase in grants was matched by a dollar, or more than a dollar, increase in expenditures (thereby stimulating additional taxes).

Conceptual problems with these early determinants studies resulted mainly from the lack of an underlying theoretical model of response. These studies gave way to somewhat more sophisticated ones beginning with Henderson (1968) and Gramlich (1969), who postulated utility maximization models. It was assumed that politicians maximize the utility of citizens in the community subject to an appropriate budget constraint. From these models equations were derived to test the impact of grants on expenditures.

These models of fiscal response are based on consumer utility maximization models applied to government behaviour.[10] In this type of model, conditional, matching, open-ended grants alter the relative price of the aided good or service, and the expenditure responses to grants of this type depend on the price elasticity of demand: if demand is of unitary price elasticity, then expenditures will increase by exactly the amount of the grant; if demand is price-elastic, total expenditures will increase by more than the amount of the grant and thus cause expenditures on all other goods to decline; finally, where demand is inelastic with respect to price, expenditures increase by less than the amount of the grant.

9 Actually, the earliest studies (Fabricant 1952 and Fisher 1961) did not use grants as a variable but only the other four variables. When the results of these studies became less and less statistically significant, a search for other explanatory variables led to the inclusion of grants in the expenditure equations.

10 For a good discussion of the theoretical response to grants, see especially Wilde (1971) and Scott (1952).

Unconditional lump sum transfers do not alter relative prices but do change the income of the community. If neither good is inferior, that is, if both goods have positive income elasticities of demand, the likely result is that an increase in grants will be matched by increased expenditures by an amount less than the grant.

Conditional, matching, closed-ended grants will have the same impact as open-ended matching grants up to the grant limit. Until the maximum grant is reached, the specific matching grant will alter relative prices to the municipality in the same way as the open-ended grant. After the maximum grant has been attained however, there is no longer a price effect but only an income effect.

The impact of grants on the budget of the recipient municipality depends on whether the grant has only an income effect or a price and income effect. This model predicts that the expenditure response is greatest for open-ended matching grants followed by closed-ended matching grants and then unconditional grants.

More recent empirical studies of the expenditure response to grants have taken account of the different responses to different types of transfers by including both the price and income effects.[11] A study by Slack (1980) for upper-tier municipalities in Ontario[12] in 1973 and 1974 estimated that unconditional grants increased local expenditures but by an amount substantially less than the grant, and thus reduced property taxes. The results for open-ended matching grants were less conclusive, however, depending on the choice of functional form.[13] However, in all cases the expenditure response to conditional grants exceeded the response to unconditional grants.[14]

11 See for example Inman (1971).

12 Municipalities in Ontario are organized into forty-nine upper tiers, which consist of a metropolitan area, regional governments, restructured counties, counties, and districts.

13 Both a Stone-Geary utility function and a translog indirect utility function were used to derive expenditure demand equations. For more details, see Slack (1980).

14 An assumption implicit in the analysis of all the empirical studies of the expenditure response to transfers is that conditional grants do not affect the choice of production technique of the aided good or service (Rasmussen 1976). However, as was seen in Table 3 some of the grants in Ontario go specifically for capital purposes and others for operating purposes. It would appear that a capital grant, for example, would make capital cheaper (assuming cost minimization) and thus the municipal government might alter its production process to

It should be remembered that the results of the models discussed so far depend crucially on the assumption that politicians maximize the utility of citizens. This assumption has been questioned by some authors, notably Niskanen (1968) and McGuire (1973). McGuire postulates a bureaucrat's model where the utility of the bureaucrat is maximized subject to a budget constraint. The bureaucrat's utility function is assumed to be composed of such attributes as power and status, which are assumed to be directly related to the size of the budget. The objective then is to maximize the size of the budget. In this model all grants are stimulative, that is, expenditures rise by a little bit more than the amount of the grant, thus resulting in a small rise in taxes. Although this model has not been tested empirically, it does suggest that the expenditure response to grants would be different from that predicted by the theory of utility maximization.[15]

Finally, the models described here do not take account of the impact of the stated objectives of the donor government on the behaviour of the recipient government. For example, in Ontario in 1973, when the property tax stabilization grant was introduced, the provincial government at that time stated that it was designed to reduce property taxes. This statement

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make it more capital-intensive. These results could have important implications for the expenditure response to conditional grants. For example, a restricted, open-ended, matching grant which subsidizes a particular factor input or a particular activity will distort the capital/labour ratio for that activity. Because the restriction will lead to 'cost increasing distortions in the local choice of production technique' (Rasmussen 2976, 215) the restricted, open-ended, matching grant is not as stimulative as a neutral, open-ended, matching grant and may not even be as stimulative as an unconditional grant. With respect to the utility maximization models summarized in this paper, it is assumed that grants do not alter the choice of production technique and that production of the public good is linearly related to expenditures made on that good. Grants are not assumed to distort factor prices. The results of these models only hold for the case where the grants are neutral with respect to factor inputs.

15 Some further work along these lines was attempted by Feldstein and Frisch (1977), who tested both a political model and a bureaucratic model to decide whether a given stage of the budget process provided examples of one model or the other. Their empirical results indicated that the political model was more useful in describing the budgetary process of schools in Massachusetts. The implications for the expenditure response to grants is that each grant is considered separately for each expenditure category as opposed to the bureaucratic model where spending in response to matching grants is the same as the response to any other increase in the budget.

of intent alone could have served to have municipalities reduce property taxes, regardless of their normal behaviour and response to grants. The impact of stated goals on grants is not easily incorporated into the utility maximization models described above.

To summarize, the studies based on utility maximization models confirm that open-ended matching grants are fairly stimulative, followed by closed-ended matching grants, and finally by unconditional grants. If the donor wishes to encourage spending on a particular activity, an open-ended matching grant is the most appropriate vehicle. It has been suggested, however, that there are a number of simplifying assumptions in these models which reduce the applicability of their results to Ontario. For example, some recent work questions the relevance of utility maximization models in analysing fiscal response to transfers. Also, some of the institutional features of the particular area being studied need to be incorporated into the model. Further research could be done in both these areas.

EVALUATION OF PROVINCIAL-MUNICIPAL GRANT PROGRAMS IN ONTARIO

In its assessment of the grant system, the Provincial-Municipal Grants Reform Committee enumerated eight problem areas: too many specific grant programs, confusion and uncertainty among recipients, excessive ad - ministrative requirements, too much entanglement, impairment of local autonomy, too many special-purpose bodies, the existence of obsolete grants, and inconsistent equalization provisions. In addition to more detailed recommendations on specific grant programs, the Committee presented nine 'strategies for reform.' These are deconditionalization of grants, block funding, privatization of particular activities now provided by the public sector, transfer of financial responsibility for some functions to another level of government, transfer of administrative responsibility, rationalization of equalization of fiscal capacity within grant programs, rationalization or simplification of the structure of grant programs, and differential reforms for different municipalities. In light of the Committee's recommendations, this section evaluates grant programs in Ontario.

Most of the above problems and solutions deal with the administration of grant programs. There are too many programs with too many compli-

cated provisions and procedures. The Committee recommended that grants be significantly simplified and reduced in number by eliminating some and consolidating others. The number of grants would be reduced from eighty-seven to thirty-seven.

One possible implication of a complex grant stucture has been stated by the Association of Municipalities of Ontario: 'Because of the variety and complexity of the present grant programs, grants are often given to astute municipalities while small municipalities miss out due to a lack of knowledge or aggressiveness in claiming grants they are entitled to receive' (reported in Ontario 1977, 17). In other words, the complexity of the current system favours richer municipalities who have the resources to develop 'grants-manship.' Standardization of grant procedures across programs could reduce this problem. Whether or not the grant system favours richer municipalities is really an empirical question, but it can be argued that some of the unconditional grants explicitly favour poorer regions, as for example, the resource equalization grant and the special Northern Ontario grant.

Other aspects of the complexity of the current grant structure make simplification desirable. The costs of administration of these grant programs both at the provincial level where grants are given out and the municipal level where grants are received likely increase with the complexity of the grant structure. Although no studies have been done of the costs associated with the administration of grant funds, one would expect that they would fall with the introduction of a simpler system. At present a number of provincial ministries are involved in administering grant funds, and all have different rules and regulations for each grant program. Similarly, a significant number of municipal employees, not only in the local government but also in boards and agencies who receive grants, must devote time to deciphering eligibility rules for grant programs and making the applications. Moreover, the grants appear to change somewhat over time: some grants are deleted, others are added, matching ratios and dollar limits change, and so forth. Thus the expertise in administering grants one year is not sufficient for a number of subsequent years. Stated another way: if grant rules and regulations remained constant for a fairly significant length of time, the expertise developed in one year to administer these programs would be sufficient over a longer time period. The simplification of the current grant structure in Ontario would probably

reduce the administrative costs at both the provincial and municipal levels of government.

The complexity of the grant structure precludes a municipality from budgeting over any length of time (such as by making four or five year plans). Because it is hard to know what grants it is eligible for in any given year, let alone over the next few years, a municipality cannot easily predict how much it will receive in grant funds. Total municipal revenues are composed mainly of property taxes and provincial grants, so that if the municipality does not have information on the amount of grants it will receive, then it cannot forecast how much it will have to raise in property taxes. A simpler system would allow more predictability of revenues and thus greater ability to budget over several years. It is interesting to note that one stated purpose of the Edmonton Commitment was to provide certainty to municipalities in their budgeting, but this applied to total grants, not the composition, and it was not strictly adhered to in any event. (Smither 1976).

The general chaos of grant programs can be explained in part by their evolution (Dupré 1967). Provincial grants to municipalities for specific services began in the nineteenth century with grants to education followed by road grants. Grants for other specific services were subsequently introduced. Many of the current programs have not changed significantly over time, regardless of changing needs. For example, road grants introduced at a time of rapid highway expansion may no longer be required. No explicit framework for grants was ever developed; only incremental changes to grant programs were made. Consequently, the current system, which evolved spontaneously, needs rationalization. This requires an outline of the objectives of the donor government and a choice of grants which will meet these objectives. Obsolete grants should be eliminated (see Table 3).

A significant proposal of the Committee is deconditionalization. Implementation of this recommendation would mean that 60 per cent of total grants would be unconditional. Unfortunately, the Committee does not outline the features of the proposed unconditional grants package. There are some recommendations concerning alterations in the existing unconditional grants (including the need for the resource equalization grant to be based on market value assessment, as will be discussed below) and recognition that deconditionalization would necessitate designing a new

grant, but no suggestions are ventured about how to design it. Given the distinction between grants which are unconditional with respect to use and grants which are unconditional with respect to receipt, there is some question whether the proposed new unconditional grant would be truly unconditional. If there are restrictions on the receipt of this grant, then deconditionlization may result merely in a new packaging of the old system. There should be some discussion of the formula of the unconditional grant under deconditionalization.

Nor does the Committee analyse the consequences of a move from more conditional to more unconditional grants. As the expenditure response to intergovernmental transfers shows, the budgetary behaviour of municipalities in response to transfers is different for conditional and unconditional grants. This would seem to suggest that the expenditure (and tax) behaviour of municipalities will be different under a system of deconditionalization than at present, although nothing can be said from these models about the new expenditure mix.[16] It seems fairly clear, however, that there could be significant changes, both in the level and mix of expenditures, which the Committee has failed to consider.

These anticipated changes in the level and mix of local expenditures served to halt earlier attempts by the provincial government to deconditionalize grants in Ontario. Library boards, for example, felt their budgets would be cut significantly if library grants were deconditionalized (Ontario, 1977, I, 11). The Committee also reported a reluctance on the part of the provincial ministries to have some of their responsibilities removed (ibid., see also Ontario Economic Council 1978, 25). Despite the failure of earlier attempts to deconditionalize grants for the reasons just stated, the Committee does not consider how to overcome similar opposition to its current proposals for deconditionalization.

The most important question surrounding the use of unconditional grants as opposed to conditional grants centres on the issue of local autonomy. Unconditional grants provide municipalities with more flexibility in expenditure decisions than do conditional grants.

Conditional, matching, open-ended grants have been justified in the economic literature on the grounds that the provision of certain services

16 These models consider marginal changes in grants and cannot really be used to predict the budgetary response to a major change in the grant structure.

result in spillovers. However, if, as was shown for Ontario, conditional grants do not appear to be for the purpose of internalizing these spillovers, there is some doubt whether local autonomy should be interfered with through the use of conditional grants.

It has been argued that donor governments generally prefer conditional grants whereas recipient governments prefer unconditional ones. However, it is also possible that some municipalities prefer to have their expenditure decisions made for them by the Province, in which case they would opt for conditional grants. A road grant would be spent on roads, for example, thereby relieving the municipality of having to decide how to allocate the grant funds. The preference for different types of grants would likely vary across municipalities. One would expect that Metropolitan Toronto might prefer the greater flexibility offered by unconditional grants but some smaller municipalities might not.

Unconditional grants are generally based on some measure of the need and fiscal capacity of the recipient municipality. More specifically, the resource equalization grant (REG) in Ontario is based on population as the measure of need and on equalized assessment as the measure of fiscal capacity or the ability of the municipality to raise its own revenues. Simplifying greatly, as the equalized assessment per capita of a municipality rises, the amount of grant it receives falls. This inverse relationship between equalized assessment and grants is an attempt at equalization - poorer municipalities, where poverty is measured by a relatively low property assessment base, receive more grants than richer municipalities, again measured by the property assessment base. Those municipalities with equalized assessment above the provincial average receive no grant and make no payment. This formula, (see note 8), then, equalizes the assessment base to the average in the province: only those municipalities with equalized assessment below the average receive a grant which brings them up to the average.

The measure of fiscal capacity, or ability to raise revenue, used in this formula is 'equalized assessment.' This is the taxable assessment of the municipality to which provincially determined equalization factors have been applied. The purpose of these factors is to correct for differences in assessment practices between municipalities, and, although equalized assessment is somewhat closer to market value assessment than is taxable assessment, there are still a number of serious shortcomings with the

equalization factors.[17] In reality these equalized values considerably understate market values. The main reason for this discrepancy is that equalization factors were frozen after 1970 as a result of the discussions on assessment and property tax reform. Property values have increased rapidly since 1970, so these factors were grossly outdated.

The Committee noted that the inequities resulting from the grant system were quite severe. The REG, which is supposed to equalize the tax base of municipalities across the province to the average tax base, was based on a highly imperfect measure of fiscal capacity. Municipalities that were over- (under-)assessed relative to the provincial average were levying higher (lower) taxes and receiving less (more) grants than they would have under a more equitable market value system.

The Committee recommended that market value assessment be used as the base for the resource equalization grant: 'the province [should] move quickly to property tax reform and the use of universal market value assessment, thereby strengthening the foundation of the resource equalization grant' (Ontario, I, 1977, 199).

In response to these problems, the Ontario Minister of Revenue announced in November 1978 that equalization factors would be unfrozen for the purpose of grants and cost apportionment.[18] He stated that equalization factors reflecting 1978 market values would be produced for use in 1979. It was promised that no municipality would receive a smaller grant in 1980 because of the introduction of these new factors. Special one-time payments were also made to forty-nine municipalities in 1979 to assist those municipalities most affected by the system of frozen equalization factors. It is still not clear, however, that the new equalization factors more closely reflect current market value (see the paper in this volume by John Bossons, which suggests that it is very difficult to determine accurately true market value).

The recent property tax reform debate has resulted in a number of different proposals for implementing market value assessment. It is important to note that provincial-municipal grants and property taxes are very closely related, so that any reform of property taxes, particularly of the assessment base, will automatically result in changes in grants. Very

17 For a discussion of equalization factors see Bird and Slack (1978a).
18 Cost apportionment is a method of assigning the costs of the upper-

little attention has been paid in the property tax reform debate to the impact on grants.

One final point: if market value assessment is not being used for property taxes (see the other two papers in this volume) then one might ask why it should be used for grants. Is market value assessment a good measure of a municipality's ability to pay for municipal grants and services? These are the kinds of questions that should also be asked in the property tax reform and grant reform discussions. The paper by John Bossons in this volume provides a more detailed discussion of the alternatives that could be used in the grant formula and why they might be superior to market value assessment.

It is hoped that this discussion has made it clear that grants and taxes are at present closely related in Ontario. In any reform both aspects have to be considered. If there is going to be property tax reform, it is crucial to ask what the impact will be on grants. The Province really needs to consider a reform of the whole municipal finance system.

To summarize: there are a number of ways in which provincial-municipal grants in Ontario could be improved. Some grants could be eliminated; most could be simplified or deconditionalized; and the basis of the resource equalization grant could be improved. In short, some attempt should be made to rationalize the current grant system by stating the objectives of the transfers and then designing programs that will meet them.

CONCLUSION

The two main justifications for intergovernmental transfers are on grounds of equity and efficiency. It has been argued that unconditional grants are most appropriate for achieving equity and conditional, open-ended, matching grants for achieving efficiency. This paper has suggested that conditional grants in Ontario do not likely improve efficiency and that unconditional grants need significant alterations to achieve equity.

The paper has also suggested that little has been done to reform the grant structure in Ontario since the Smith Committee report was published over a decade ago; it has made some specific recommendations for sim-

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tier government among the lower-tier governments. This is at present done using equalized assessment.

plifying grants and improving unconditional grants; and it has argued that grant reform should coincide with property tax reform.

The main reason why the current grant structure is chaotic is historical. Grants have evolved since the beginning of the nineteenth century. As requirements changed, new grants were added, but there has never been any attempt to rationalize the grant system, to state the objectives and then design grant programs to meet them. It is essential that the grant structure in Ontario be rationalized as a whole rather than continuing to receive only incremental changes in specific programs.

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